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DISCUSSION PAPER 42

Has Belgian fiscal decentralisation reduced the size of government and the budget deficit?

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Contents

Has Belgian fiscal decentralisation reduced the size of government and the budget deficit?[1]

Samenvatting

1) Het Belgische begrotingsfederalisme, tenminste dat tussen de federale overheid en de Gewesten & Gemeenschappen (G&G), is gebouwd op ***dotaties***. Deze maakten tot in 2013 ongeveer 80% van de ontvangsten van de Belgische G&G uit, en zullen vanaf 2014 ongeveer 68% van deze ontvangsten blijven uitmaken. Daardoor is de zogenaamde Verticale Begrotingskloof –ook dotatie-afhankelijkheid genoemd- tussen de centrale overheid en de G&G in België één van de grootste van de OECD-landen. In de theorie van het begrotingsfederalisme echter wordt er vanuit gegaan dat lagere overheden hun uitgaven in hoofdzaak met eigen belastingen financieren, en slechts in bijzaak met dotaties. Dotaties verbreken de band tussen de belastingbetaler, de kiezer en de gebruiker van publieke goederen, terwijl eigen belastingheffing de burger in deze 3 hoedanigheden doet samenvallen.

2) Het overwicht van dotaties in de financiering van de G&G vertekent het politieke debat inzake begrotingsfederalisme in België sterk in de richting van verdelingsvragen: “welke G&G krijgt meer/minder?” en “welke overheid is over-/ondergefinancierd, de federale overheid of de G&G?”. De empirische literatuur inzake begrotingsfederalisme stelt echter belangrijkere gevolgen van de “dotatie-belastingautonomie-mix” vast dan verdelingseffecten. De grote dotatie-afhankelijkheid van de G&G in België maakt dat het begrotingsbeleid van de G&G ***gericht is op het gedrag van de centrale/federale overheid***. Ze is een argument om België niet als een volwaardig gedecentraliseerd land te beschouwen.

3) Met de staatshervorming van 1989 ging België bij de groep van vrij gedecentraliseerde OECD-landen behoren, tenminste aan de uitgavenkant. Sindsdien vinden we in periodes van verslechtering van de begrotingssaldo’s van individuele Belgische overheden, of in aankondigingen van individuele overheden dat ze hun saldo niet zouden verbeteren zolang hun dotaties niet zouden worden verhoogd, illustraties voor het gebrek aan een eigen, onafhankelijk, en verantwoordelijk begrotingsbeleid van de G&G –maar ook van de federale overheid zelf. In lijn met de internationale empirische literatuur over het ***effect van een “zachte begroting”*** zouden dergelijke hogere begrotingstekorten van individuele Belgische overheden tactisch kunnen zijn geweest. D.w.z. ze zouden kunnen zijn opgelopen door de G&G in de verwachting daardoor extra dotaties te verkrijgen van de federale overheid. Dergelijke extra dotaties werden beslist voor de Gemeenschappen in 1993 en 2001, en voor het Brussels Hoofdstedelijk Gewest in 2013. Omgekeerd zouden in het geval van de federale overheid zelf

[1] I thank Koen Algoed, Thushyanthan Baskaran, Hansjörg Blöchliger, Robin Boadway, Peter Claeys, Colette Coppens, Danny Geerts, Klaas Staal, David Stadelmann, and my colleagues at Vives, whose respective inputs have been instrumental in writing this paper.

begrotingstekorten mede kunnen zijn opgestapeld met het oog op een vermindering van haar dotaties aan de G&G. Een dergelijke globale vermindering werd beslist in 2013.

4) We vrezen dat de opeenvolgende dotatieverhogingen als antwoord op opgelopen begrotingstekorten hebben geleid tot een verslechtering van het globale Belgische begrotingssaldo, en dat ook de dotatievermindering toegestaan aan de federale overheid in 2013 daar in de toekomst toe zal leiden. De empirische literatuur inzake begrotingsfederalisme heeft voor verschillende landen, o.m. Duitsland, Spanje en Zweden, een vicieuze cirkel aangetoond. Deze bestaat eruit dat een overheid in een context van een "zachte begroting" extra dotaties vanwege andere overheden uitlokt. Deze extra dotaties versterken op hun beurt nog de context van een "zachte begroting". ***Begrotingstekorten die erin slagen extra dotaties te generen, leiden tot nieuwe begrotingstekorten***. We mogen aannemen dat in België de extra dotaties van 1993 en 2001 een onmiddellijke verslechtering van het begrotingssaldo van de verstrekkende federale overheid tot gevolg hebben gehad. Maar nog belangrijker is dat ze naar verwachting ook een ongunstig middellange-termijn-effect op het globale Belgische begrotingssaldo hebben gehad doordat de ontvangende overheden hun begrotingsdiscipline niet verbeterd hebben. Hetzelfde mag in de toekomst worden gevreesd voor de extra dotaties ten gunste van het Brussels Gewest en voor de dotatievermindering ten gunste van de federale overheid die in 2013 werden goedgekeurd.

5) Eén van de motivaties voor begrotingsdecentralisatie in België was het oplossen van het "***common pool problem***" dat zich stelde inzake het begrotingsbeleid van het unitaire België. Maar de manier van begrotingsdecentralisatie in België deed het "common pool problem" terugkeren in de vorm van "zachte begrotingen" van de individuele Belgische overheden.

6) Wij menen dat de pogingen in België om begrotingsdiscipline te verwezenlijken via ***expliciete begrotingsinstituties*** zoals de Belgische Samenwerkingsakkoorden inzake vermindering van het globale begrotingstekort en een "begrotingswaakhond" zoals de Hoge Raad van Financiën (HRF) niet dezelfde gunstige begrotingsresultaten heeft opgeleverd als die die zouden zijn opgeleverd door het oprichten van bepaalde ***impliciete begrotingsinstituties***. Impliciete begrotingsinstituties zoals een hoge belastingautonomie en een -mee daardoor geloofwaardige gemaakte- "no-bailout commitment" –geen periodieke dotatieverhogingen (noch dotatieverminderingen)- vanwege de federale overheid hebben gezorgd voor lange-termijn-begrotingsdiscipline in bijvoorbeeld Canada en Zwitserland.

7) Net als in het verleden zal ook in de toekomst het verhogen van de belastingautonomie van de G&G moeizaam kunnen worden verwezenlijkt. "Natuurlijke" tegenstanders hiervan zijn in België –net zoals in andere landen- de federale overheid, die haar belastingmacht niet uit handen wil geven, en die G&G die worden gekenmerkt door een zwakkere belastinggrondslag dan gemiddeld, temeer doordat in de voorbije decennia de belastinggrondslagen van de Belgische gewesten gedivergeerd zijn. België bevindt zich ***in een "catch22"-toestand met het oog op het bereiken van een begrotingsfederalisme gebaseerd op belastingautonomie***.

1.Introduction

This paper studies the effects of Belgian fiscal federalism/ fiscal decentralisation on the size of government and on the overall fiscal balance[2]. The effects of Belgian fiscal federalism/ fiscal decentralisation have so far hardly been studied empirically. This holds in particular for the relationship between the federal government (FG) and the "states", i.e. the intermediate government level between the FG and the local governments, which are called the Regions and Communities (R&Cs) in Belgium. Hence, insufficient empirical evidence is available to assess whether the process of Belgian fiscal decentralisation to the R&Cs has been fiscally beneficial overall, i.e. whether it has reduced the overall cost of government and improved the overall budget balance compared to the baseline of Belgium having remained a unitary state.

This lack of empirical evidence is a disappointment, in particular compared to the wealth of empirical research that is already available in the field of fiscal federalism in other relatively small – in terms of population- but decentralized countries. Examples are Canada (see e.g. Boadway 2004 and Dahlby and Ferede 2012), Sweden (see e.g. Dahlberg 2008 and Pettersson-Lidbom 2010), and Switzerland (see e.g. Eichenberger and Stadelmann 2010 and Jametti 2012). Additionally a considerable body of empirical literature based on panel data for OECD countries has come into existence. This literature generally finds a favourable impact of fiscal decentralisation / fiscal federalism on the –overall- cost of government and the –overall- budget balance. (for an overview, see e.g. Boadway and Shah 2009 pp. 464-497)

An explanation of the dearth of research on Belgian fiscal federalism as far as the R&Cs are concerned could be the limited number of "cross-sections" available in Belgium for empirical analysis. In Belgium the number of R&Cs is extremely limited. The state level consists of 3 Regions and 3 Communities, some of which are interdependent[3]. Hence, in what follows we will have to limit ourselves to assessing whether the process of Belgian fiscal decentralisation to the R&Cs has overall been fiscally beneficial merely on the basis of an analysis of the history of Belgian fiscal decentralisation towards the R&Cs. We will base our analysis on the international empirical literature on the fiscal effects of fiscal decentralisation.

[2] Our main criterion will be the ***overall*** Belgian budget balance, and not the budget balance of the federal government or the budget balance of the R&Cs taken separately. Indeed, an improvement of the former may come at the expense of the latter, or vice versa. Within a single country, all separate budgets may in fact be "communicating vessels".

[3] Strong interdependencies exist both in terms of budgets and of politicians between the Flemish Region and Community (effectively merged), as well as between the French Community, the Brussels Region and the Walloon Region. The latter three are characterized by an overlap of politicians –the Councils of Ministers of the Walloon Region and the French Community were merged recently-, cross-subsidization of budgets – e.g. by means of the 1993 Saint Quentin decree and the 2001 Saint Boniface agreement, and exchange of efforts of deficit reduction – "transfers of norms"- in view of respecting the "Belgian internal stability pact" (see e.g. HRF 2013b p. 100-104). The Brussels and Walloon Regions have provided extra funding to and/or have taken over responsibilities from the French Community. This contrasts with e.g. the number of –clearly delineated- US states (50), Swiss cantons (26), Canadian provinces and territories (13), Spanish Autonomous Communities (17) and German Länder (16).

Our major conclusion will be that the heavily grants-based nature of Belgian fiscal federalism, and the ensuing changes in the grant system, could have increased the overall cost of government in Belgium, as well as that it could have negatively affected the overall budget balance. We will therefore recommend a rebalancing of the Belgian tax-grants balance towards more tax autonomy for the R&Cs.

Our unfavourable conclusion on the effects of Belgian fiscal decentralisation contradicts most of the scant literature on this subject. The major fiscal decentralisation round in Belgian history in financial terms, i.e. the voting of the Special Financing Act (SFA) in 1989, transferred important expenditure responsibilities from the FG[4] to the R&Cs, and detailed the federal grants that would finance these responsibilities. At the same time the 1989 decentralisation round happened in the middle of a period of drastic broad improvement of fiscal management in Belgium (1982-1999)[5], i.e. in a period in which both the overall size of government and the overall budget deficit were brought under control (see graph 1[6]). IMF (2003 p. 14), DG Ecfin (Bethuyne 2005), Spahn (2007 p. 19), Karpowicz (2012 p. 6) and Pagano (2013) all seem tempted to take association for causation, as all of them too hastily conclude that Belgian fiscal decentralisation since 1989 has contributed to the improvement of fiscal policy in Belgium.

As a counterexample, the fiscal decentralisation round of 1999/2001 illustrates that in Belgium fiscal decentralization has not always gone hand in hand with improved overall fiscal management. The 1999/2001 round included an increase in grants to the Belgian Communities without an increase in their expenditure responsibilities. It coincided with –and contributed to (see e.g. Blöchliger and Vammalle 2012)- a period of ***deteriorating*** fiscal management, possibly aided by the fact that Belgium had just gained accession to the Euro-zone in 1999[7].

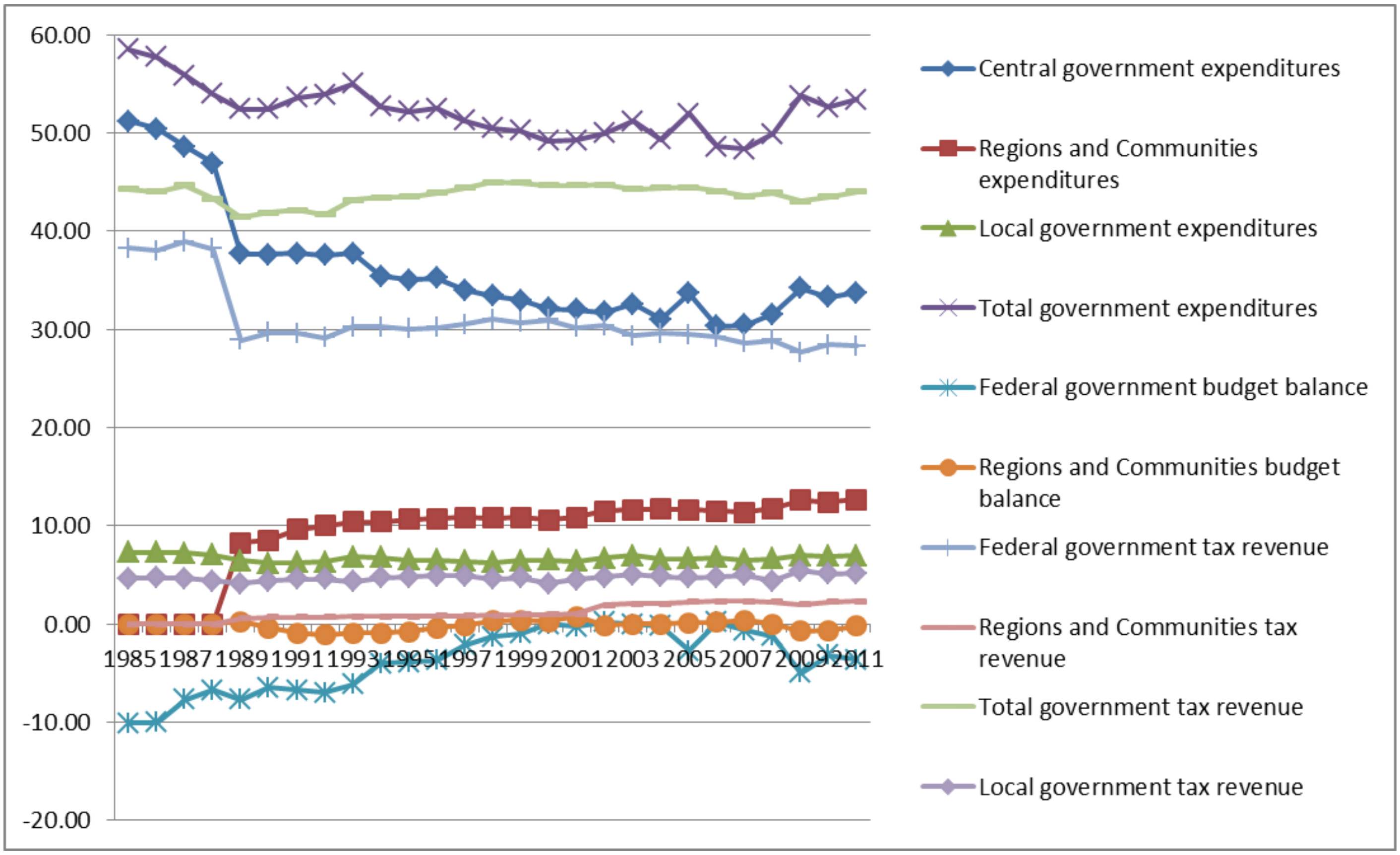
[4] In this text, whenever we mention the FG, we mean “the FG, including social security”, as social security is formally the FG’s responsibility in Belgium –though in practice largely “outsourced” to federal employers’ and employees’ organisations.

[5] However one could also argue that, since fiscal deficits in Belgium in the 70s and the early 80s were so large and debt accumulation so rapid, this improvement started from such a low base that its merits should not be overestimated.

[6] Budget balances of local governments and of total Belgian government are not shown, because the former have been close to zero as a % of GDP, and the latter have always been close to equal the central government budget balance over the period considered.

[7] It should however be admitted that fiscal decentralisation has probably led to an overall reduction of the -fiscally harmful- common pool problem in Belgium. Pork barrel politics has probably decreased since almost all major investment expenditure categories were devolved to the R&Cs in 1989. E.g., OECD (1994 p. 31) wrote that before fiscal decentralisation “the {Belgian} budget was kind of a free-for-all in which the allocation of resources gave rise to all kinds of haggling and trade-offs between the various regional entities (…) meaning that often resources were wasted”. But this may rather imply that ***lack*** of fiscal discipline ***induced*** –requests for- fiscal decentralisation, rather than that fiscal decentralisation ***induced*** fiscal discipline. Besides, already with the newly elected government coalition of 1982 –i.e. before major expenditure categories had been devolved-, Belgium had started its long and painstaking journey towards expenditure and deficit control.

Graph 1: expenditures, tax revenues[8] and budget balances of the Belgian government levels as a % of GDP[9]



Source: OECD

In what follows, we will first elaborate the crucial concept of the tax-grants balance of financing subcentral governments (SCGs), i.e. on the Vertical Fiscal Gap (VFG), and compare this VFG within an OECD context. Next, we will give an brief overview of the empirical literature that has demonstrated why the VFG is important for the overall fiscal balance of decentralized countries. Thereafter we will provide arguments as to why the high VFG between the FG and the R&Cs in Belgium in particular could have led to an increase in overall government expenditures, as well as to a deterioration of the overall fiscal balance. In a subsequent chapter, we will complement our analysis of the adverse effects of the high VFG on budget discipline in Belgium with a number of additional potential causes of a Belgian soft budget effect. We will conclude our analysis with a critical overview of the attempts to coordinate fiscal policy between the Belgian FG and the R&Cs over the past decades.

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[8] Central government tax revenue ***remaining after*** transfers to subcentral governments.

[9] In this paper, whenever we use GDP, we mean ***total*** GDP of the country in question.

2.The vertical fiscal gap

2.1.Concept

Belgium belongs to the group of OECD countries which combine rather high overall expenditures and debt with rather low expenditure decentralisation (at least until 2013) and with low tax decentralisation. (see Annex 1 for a detailed international comparison of fiscal decentralisation in OECD countries) Hereafter we will argue that –in line with what is also suggested by the graphical analysis in Annex 1- fiscal decentralisation in Belgium may not have been sufficient to be conducive to better overall fiscal management. We will make this argument by taking into account the empirical literature on fiscal decentralisation in OECD countries. Not only ***both*** Belgian expenditure decentralisation (at least until 2011) ***and*** tax decentralisation ***taken separately*** seem rather low when compared with the most other EU15 + G7 countries, but also the ***vertical fiscal gap*** (VFG) in Belgium has always been one of the highest in the OECD. The VFG measures the ***difference*** between expenditure and tax decentralisation, i.e. it measures the SCG revenue ***composition***, also called the tax-grants balance or transfer dependency of SCGs. I.e. tax decentralisation in Belgium has always been much smaller than expenditure decentralisation. In other words: the extent to which Belgian R&Cs are grant financed has always been much higher than the extent to which Belgian R&Cs are financed by own tax revenue.

The effects of the size of the VFG should not be underestimated. Blöchliger and Petzold (2009 p. 4): "Own tax revenue and grant revenue differ in the way they are generated, allocated and distributed to SCGs, thereby shaping decisions of all government levels about where, when and on what to spend money. The sub-central revenue composition or revenue mix is hence likely to affect fiscal outcomes such as public sector efficiency, equity in access to public services or the long term stability of public finance at both the central and the sub-central level".

But first, we should state that the existence of a VFG is probably desirable, and could even be too low in some countries[10]. This is because there is an economic case to be made for SCGs having a lower share in total tax revenue raised than in total expenditures made. The risk of ***vertical*** tax externalities makes that the central government (CG) has a comparative advantage in raising taxes compared to SCGs. I.e. in case one or more tax bases are co-occupied by a higher and a lower level government, there is a risk of a "race to the top" in tax rate setting between them, thereby reducing these tax bases and ultimately overall tax revenue. This risk is compounded by the risk of ***horizontal*** tax externalities, i.e. in case one or more tax bases are co-occupied by several lower level governments. In this case, "races to the bottom" in tax rate setting between them could emerge. These could in turn lead to a shifting of the tax base

[10] See e.g. Boadway (2003 p. 12 and following) in which a case is made for ***increasing*** the VFG in Canada.

between their territories and also ultimately to loss of tax revenues for all of them (see Dahlby 2008 for a major theoretical contribution on tax externalities[11]).

However, according to Blöchliger and Petzold (2009 p. 13) horizontal tax externalities could risk starting a "race to the bottom" only if SCGs have high taxing power and significantly rely on sales taxes. This is the case mainly in the US, where autonomous sales taxes account for 50% of state and 20% of local tax revenue. Moreover when the VFG becomes too high, the disadvantages of the VFG probably start outweighing the advantage of avoiding or limiting tax externalities. Blöchliger and Petzold (2009 p. 10-18) give an overview of the arguments for and against intergovernmental grants, concluding that the latter outweigh the former.

2.2.International comparison

Graphs 2a and b show the VFG, i.e. the degree of grant-financing of SCGs, for those OECD countries in graphs 12a and b in Annex 1 in which subcentral expenditures made up at least 30% of overall public expenditures. We define the VFG for convenience as the difference between subcentral expenditures as a % of overall government expenditure and own subcentral tax revenues as a % of overall tax revenue[12]. Unsurprisingly, a considerable overlap appears between the group of countries with the lowest VFG (graph 2b) and the group of countries with the highest share of own subcentral tax revenue in total tax revenue (graph 15a in Annex 1) (Canada, Switzerland, US, Sweden, and Spain). The Spanish VFG appears to have decreased less dramatically than that the Spanish share of own subcentral tax revenue in total tax revenue increased over the time period considered; the reverse holds for Denmark. This could be because the Spanish subcentral tax revenue increase was accompanied by a subcentral grants revenue increase. Similarly unsurprisingly, a considerable overlap appears between the group of countries with the highest VFG (graph 2a) and the group of countries with the lowest share of own subcentral tax revenue in total tax revenue (graph 15b in Annex 1) (Austria, Belgium[13], Germany and the Netherlands). In spite of the increase of subcentral tax autonomy in Belgium over the period considered, the Belgian VFG has remained more or less constant at a high level over the period considered[14]. This was because the increase in subcentral tax autonomy was accompanied by an increase in subcentral grant financing.

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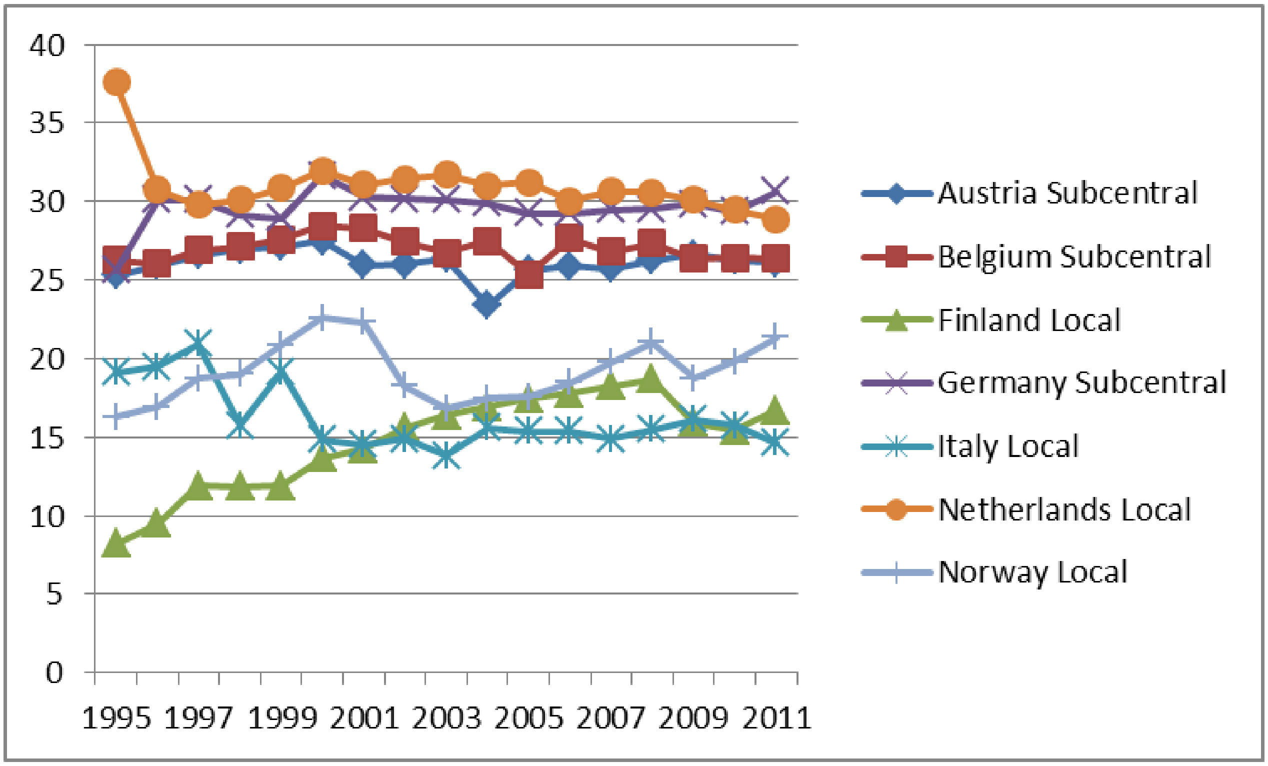
[11] Empirical contributions on tax externalities are Brülhart and Jametti (2006), Esteller-Moré and Sollé-Ollé (2001), and Dahlby and Ferede (2012). These studies find significant negative overall tax externalities for respectively Switzerland, the US and Canada.

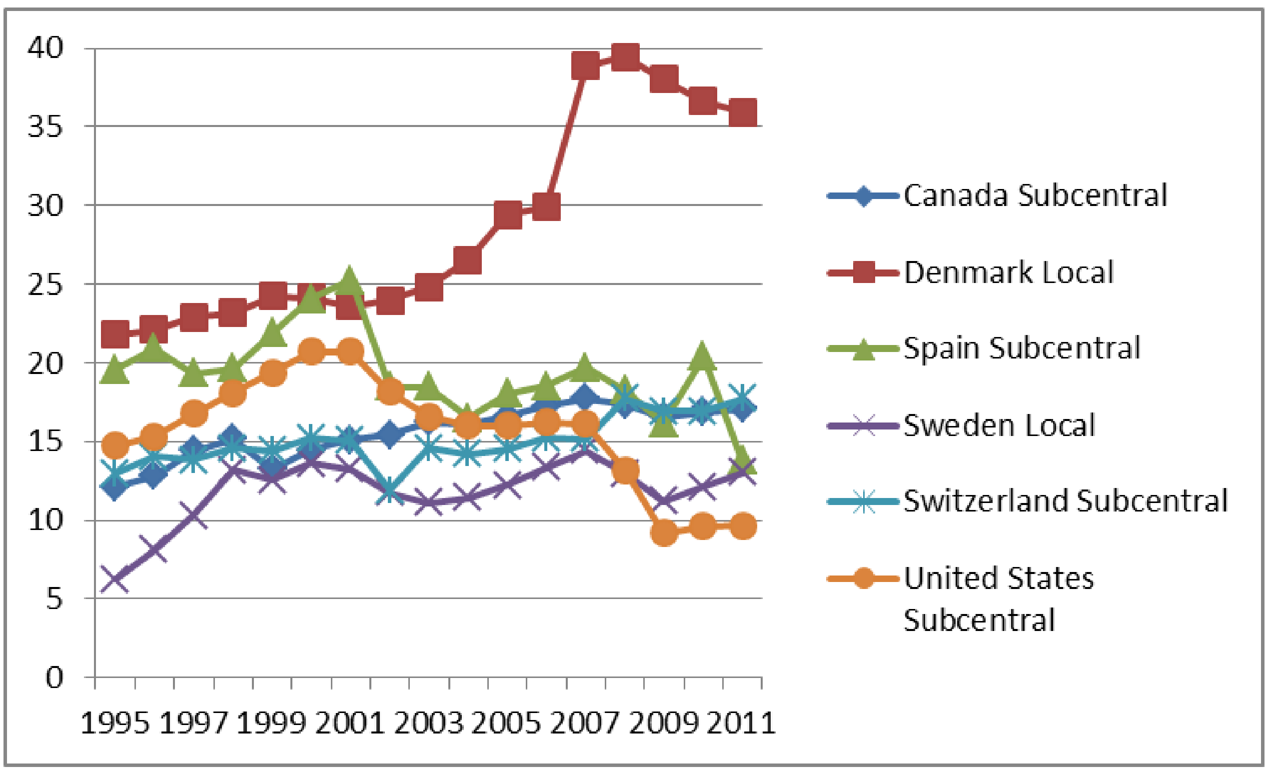
[12] I.e. our definition assumes for convenience that both subcentral and overall deficits are small in most years. We do not use subcentral ***revenue*** as a % of overall government ***revenue***, to compare to subcentral tax revenues as a % of overall tax revenue. This is because OECD data for the former appear incomplete.

[13] Because of the 2013 SFA revision, the VFG in Belgium will increase to an estimated 28% in 2014, from 26% in 2011 (see graph 2a). Hence, also after 2013 Belgium will still belong to the group of OECD countries with a high VFG.

[14] Also when compared to ***all*** OECD countries, not just to the 13 countries with the highest share of subcentral expenditures shown in graphs 12 in Annex 1, the Belgian VFG is (very) high (see e.g. Blöchliger and Pinero-Campos 2012 p. 13).

Graphs 2a and b: VFG (as difference between SCG expenditures and revenues, both as a share (%) of total expenditures and revenues respectively)

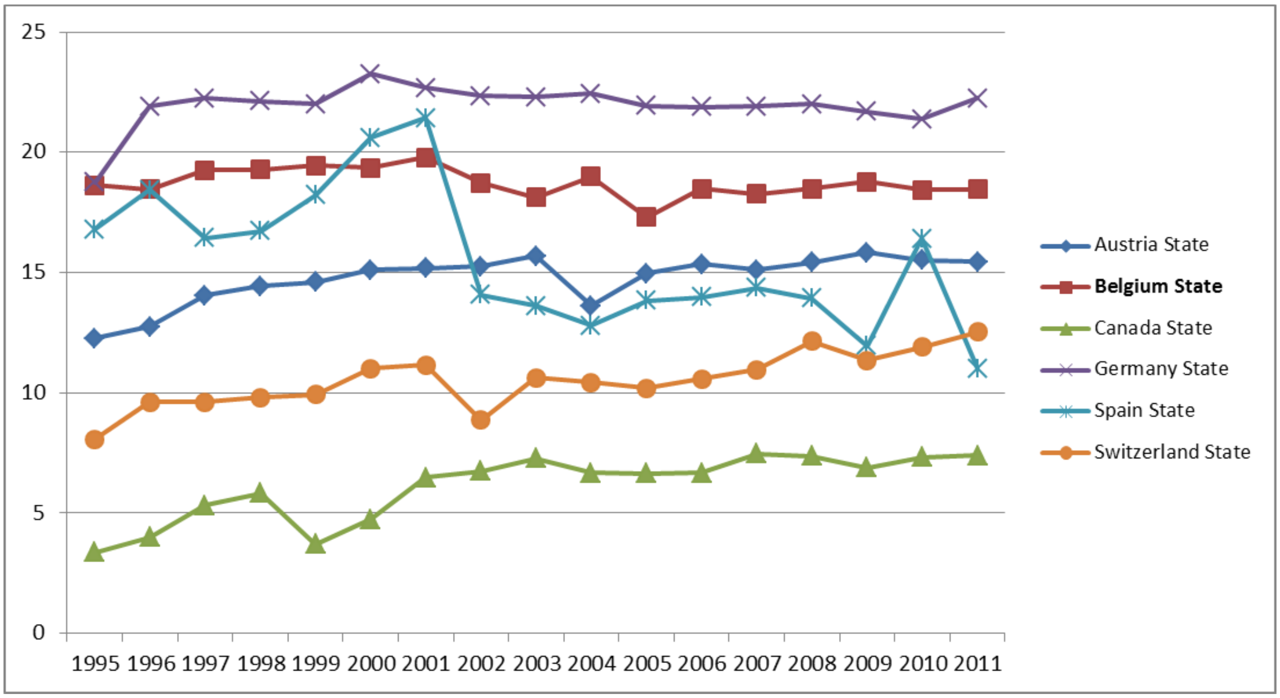




Source: OECD

For the sake of completeness, similar to graph 7, graph 3 shows the VFG as the difference between shares of ***state*** expenditures only in total public expenditure and shares of own ***state*** tax revenue only in total tax revenue, for those OECD countries with an important state level[15]. Similar to the link between graphs 6 and 8, all countries in graph 3 with a rather ***low*** state VFG (Canada, Spain, Switzerland) are countries with a rather ***low*** overall VFG in graph 2, and all countries in graph 3 with a rather ***high*** state VFG (Austria, Belgium[16], Germany) are countries with a rather ***high*** overall VFG. From a comparison of graph 3 with graph 7 we also conclude that the VFG of the Belgian R&Cs is higher than the VFG of the Belgian local governments[17].

Graph 3: VFG of states only



Source: OECD

Graphs 2 and 3 show that Belgium is a case of heavily grants-based fiscal federalism[18]. After the 2001 SFA reform –the first fiscal decentralisation round comprising an important increase in tax autonomy of the R&Cs- still only about 20% of the expenditures of the R&Cs were financed by own taxes. This share

[15] Again with the exception of Australia.

[16] Because of the 2013 SFA revision, the VFG of the states in particular in Belgium will increase to an estimated 20% in 2014, from 18% in 2011 (see graph 3). Hence, also after 2014 Belgium will still belong to the group of countries with a high state VFG.

[17] For tax autonomy as such, this is already visible from graph 1.

[18] Flemish observers sometimes prefer to disapprovingly label Belgian fiscal federalism as “consumption federalism” or “chequebook federalism” (see e.g. Algoed e.a. 2007 p. 17-29, Algoed e.a. 2008 and Algoed 2009a p. 1-4, which have all inspired the current analysis of Belgian fiscal federalism). By “consumption federalism” it is meant that “the bill” of R&Cs’ expenditures is passed on to the FG. The international fiscal federalism literature sometimes uses the –flattering?- term “cooperative fiscal federalism” to describe the Belgian –but also the Austrian and German- system, as opposed to the –denigrating?- “competitive fiscal federalism” label used to describe the systems of Canada, Switzerland and the US.

will increase to 32% after the 2013 decentralisation round, thanks to the extension of the surtax on the Personal Income Tax (PIT) that the Regions will be allowed to raise[19].

On the basis of the empirical fiscal federalism literature we will argue below that the Belgian grants-based fiscal federalism is likely to have both an unfavourable effect on subcentral public expenditures ***directly*** –the flypaper effect- and ***indirectly*** –the soft budget effect.

3.*Direct* effect of Belgian grants-based fiscal federalism on (total) government expenditures: the flypaper effect

Belgian grants-based fiscal federalism may have increased (total) government expenditures directly. This is because we would expect a stronger ***flypaper effect*** if the VFG is higher. It has often been demonstrated in the fiscal federalism literature that subcentral expenditures are higher when they are financed with –general purpose- grants rather than with own taxes (see e.g. for a literature review Inman 2008). Most instances in which the flypaper effect has been demonstrated concern an ***increase*** in grants to SCGs ***without*** an increase in expenditure responsibilities. (see e.g. Dahlberg 2008 for Sweden) However, Eyraud and Lusinyan (2011) and Konings (2011) also found that ***in general*** larger grant financing leads to higher overall expenditures for OECD countries, respectively for SCGs in general and for municipalities[20].

For the US it has been found that 30 to 100% of an increase in grants vs 20 to 50% of an increase in taxable personal income is translated into public expenditures. (Inman 2008 p. 3) I.e. if extra income enters the territory of a SCG via extra –general purpose- grants from a higher level government, more of it is translated into public spending than if that same amount of extra income enters via an increase in its citizens' personal income. Hence the label "flypaper effect": "money sticks where it hits", either with the local government –in terms of higher public expenditure- or with the local citizen -in terms of higher private consumption. Theoretically, this is puzzling, because one would expect that from the perspective of the median voter –i.e. the decisive voter- a 1 euro increase in grants to his jurisdiction would be equivalent to a 1 euro increase in his private income. Of a 1 euro increase in his private income, the median voter would vote to spend only a part -say at most 50 cents- on public goods. He would prefer to use the remainder for private consumption. Thus, since an increase in grants would be expected to be equivalent to an increase in local private income, the median voter would also vote to use at least 50 cents of a 1 euro increase in grants to increase his private consumption, which implies a tax reduction.

[19] Instead of from below 50% to 70% as the OECD (2013 p. 24) claims, since OECD (2013) wrongly only considers the tax autonomy of the Regions, and not that of the Communities.

[20] Likewise, Liberati and Sacchi (2003) find for OECD countries that tax decentralisation decreases the size of government. However, interestingly, they distinguish between tax decentralisation as tax sharing and tax decentralisation as tax separation. They have found that only tax separation decreases the size of government. Tax decentralisation therefore only seems a necessary condition for a decrease in the size of government, not a sufficient one.

However, such a tax reduction as a consequence of a grants increase has been found to take place to a much smaller extent than would have been expected from a theoretical median voter perspective[21].

The cause of these –apparently- differing reactions of lower level governments to a –general purpose- grants increase versus to an increase in the tax base for the same amount is in essence fiscal illusion. Intergovernmental grants constitute a rupture in the relationship between voters and governments. Grants cause the consumers of grants financed public goods to differ –at least in their perception[22]- from the taxpayers paying for the grants, causing local politicians to provide more public goods –or the same amount of public goods but at a higher cost- than that they otherwise would have done[23]. One of the consequences of such a separation of the taxpayer from the voter / user of public services is that the incentive for users of subcentral public services to compare its jurisdiction with other jurisdictions is taken away. I.e. the part of the abovementioned "race to the bottom" that is not welfare-reducing but welfare-increasing is prevented from happening, leading to higher public expenditure. In other words: grants avoid the "yardstick competition" between SCGs that tax autonomy would generate. E.g., Brueckner (2004) discovered the conditions for such positive consequences of tax decentralisation on local expenditure efficiency.

In Belgium, the flypaper effect has been demonstrated at the municipality level (Bastiaens e.a. 2001 and Heyndels 2001). At the R&Cs level in Belgium, there is only anecdotal evidence of this effect. E.g., Eugène (2008) found that education in Francophone Belgium –which is the responsibility of the 100% grants financed French Community- is very inefficient[24]. As another illustration, graph 4 shows expenditures, revenues, and revenue composition of the Belgian R&Cs as a % of GDP. A flypaper effect is not obvious from graph 4. Perhaps even on the contrary: the major ***increase in tax autonomy*** of 2001 which is obvious from graph 4 –and which was compensated by a ***reduction in grants*** by the FG-, does

[21] This theoretical explanation is indebted to a conversation with Thushyanthan Baskaran.

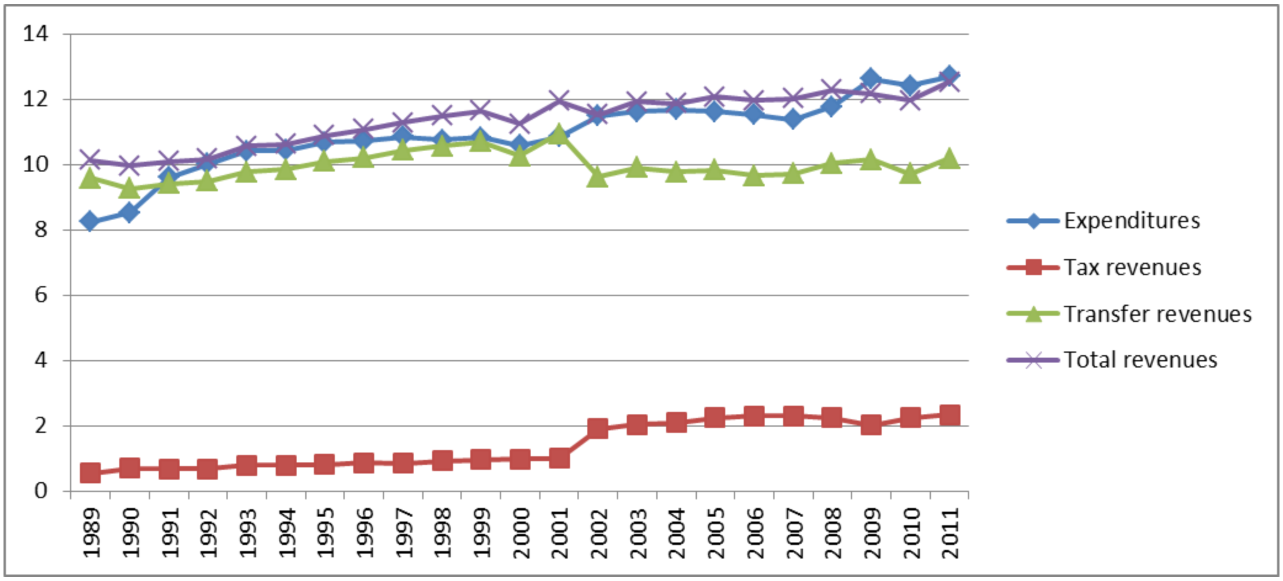
[22] In the Belgian case, in which every R&C receives federal grants in a proportion not very different from the share of federal tax revenue raised on its territory in total federal tax revenue, the rupture between taxpayers and consumers is of course largely a matter of ***perception***. E.g., the public goods provided by the Flemish R&C to the Flemish citizens are of course largely financed with taxes raised by the FG from ***those same Flemish citizens***. The type of fiscal illusion here is hence not so much that Flemish citizens wrongly assume that their public goods are paid by taxpayers ***other*** than themselves, but that Flemish citizens are not aware that federal grants ***to the Flemish R&C*** are in fact grants ***to themselves***. (see Mueller 2005 p. 221 and 224) Hines and Thaler (1995 p. 223) call this misperception "households' violation of fungibility in evaluating their politicians": "when a local government receives a grant, the choices to the public are not framed as ***between spending the money and cutting taxes***, but rather ***how*** the money should be spent", while "in theory the distinction between having money on hand and being able to raise money without difficulty should have no impact on spending decisions".

[23] Other plausible causes have been suggested in the literature: Filimon e.a. (1982) hypothesize that grants differ from local tax revenue in that budget maximizing local politicians/bureaucrats are able to ***hide*** the amount of grants received from the eyes of their citizens/voters. This cause boils down to another variant of fiscal illusion.

[24] Admittedly, it could be a stretch to ***ascribe*** this inefficiency to the 100% grants-financed nature of the French Community. Possibly the French Community is grants-financed ***because*** it is inefficient, rather than the other way around (see e.g. the reasoning in Blöchliger and Vammalle 2012 p. 18: inefficient governments prefer grants-financing and oppose tax autonomy). Also, in the same study this inefficiency is not found for Flemish education, although it is also heavily grants-financed, and although anecdotal evidence exists about inefficiencies in Flemish education as well.

not seem to have been associated with a decrease in –or even a stabilization of- expenditures later on. In plain wording: the increase in own tax revenue from 2002 onwards seems to have been translated into expenditures by the R&Cs as fully as increasing grant revenue had been translated into expenditures before 2002.

Graph 4: Expenditures, revenues, and revenue composition of Belgian R&Cs as a % of GDP



Source: OECD

4. *Indirect* effect of Belgian grants-based fiscal federalism on (total) government expenditures, i.e. via the fiscal balance: the soft budget effect

4.1. Definition and international empirical evidence

It has been demonstrated for OECD countries that grants-based fiscal federalism leads not only to higher expenditures, but also to higher subcentral (or overall) budget deficits (e.g. Asatryan e.a. 2012, Eyraud and Lusinyan 2012, and Eyraud and Moreno Badia 2013a). E.g., Eyraud and Lusinyan (2012) find that the overall fiscal balance of an OECD country improves with 1% of GDP for every decrease of 10%points in its VFG. However, these multi-country studies have ***not*** shed light on the ***mechanism*** through which intergovernmental grants deteriorate the budget balance. It is only empirical country studies specifically on the ***soft budget effect*** that have shed light on ***how*** the specific case of –discretionarily decided- ***extra*** grants to SCGs ***without*** any increase in expenditure responsibilities are able to negatively affect the subcentral and hence the overall budget balance. (see e.g. Pettersson-Lidbom 2010 for Sweden; Rodden 2005, Baskaran 2012 and Ciaglia and Heinemann 2012 for Germany; and Sorribas-Navarro 2011 for Spain[25])

Because all 3 SFA revisions so far have saliently included extra grants to one or more Belgian governments, meant to improve their budget balance and/or to prevent them from scaling back public services perceived as essential, we will devote most of our attention to the latter effect.

Blöchliger and Petzold (2009 p. 15) define the complex and simultaneous nature of the soft budget effect as follows: "The grant system may cause self-propelling growth of deficits and debts. Depending on the political economy environment, CGs can sometimes give in to SCGs demands for bailouts or other forms of fiscal support, thereby blowing up the grant system. Aware that the CG is helping them out, SCGs increase their deficits and/or their debt in the next period expecting to obtain even more grants. There is evidence that SCGs expecting a bailout borrow more than SCGs not expecting a bailout. SCGs face a soft budget constraint, and transfer growth becomes endogenous: deficits bring about more grants, and more grants bring about higher deficits."

The soft budget constraint literature analyses this paradoxical relationship between extra grants to SCGs and their fiscal balances. Rodden (2005 p. 182 and following) analyses how "incentive problems

[25] Not only are there relatively few empirical studies available of the soft budget effect. In a nutshell, this is because bailout expectations are hard to measure. Also it is striking that the few empirical country studies estimate the soft budget constraint effect by means of quite differing regression specifications, which additionally points at the complexity of the phenomenon. E.g., while Pettersson-Lidbom and Rodden essentially estimate the effect of grants on debt, Sorribas-Navarro essentially estimates the reverse relationship. Baskaran identifies a soft budget effect in an even more different way: he regresses the budget deficit of individual German Länder on the budget deficits of the German federal government and on the budget deficits of the other Länder. He finds that a German Land strategically increases its budget deficit if the other German Länder increase theirs but not if the federal government increases its deficit, thereby anticipating a federal bailout.

embedded in the German system of fiscal federalism have led to a growing debt problem among the Länder and placed heavy burdens on the FG". Pettersson-Lidbom (2010 p. 157, 162) finds that those Swedish local governments that were expecting a bailout in the 1980s and 1990s, increased their debt by on average 20%. He summarizes this soft budget effect as follows:

- "Local governments that repeatedly receive bailouts also have the highest expectations of getting additional grants in the future, and as a result, ***worse*** fiscal policy outcomes."
- "Swedish discretionary transfers to local governments were ***causing*** rather than solving problems."

Pettersson-Lidbom (2010 p. 175) establishes a link between the soft budget effect and the flypaper effect. He finds that in Sweden the soft budget effect, i.e. the worsening of the fiscal balance due to extra discretionary grants to a number of local governments, only operated through an increase in ***spending*** by those local governments, and not through a decrease in their tax revenues, i.e. through a lower tax effort. This finding blurs the dividing line somewhat between the flypaper effect and the soft budget effect. Still, the soft budget effect is a reaction of the local government ***to the behavior of the higher level government*** in view of receiving extra grants. In contrast, the flypaper effect is the difference in reaction of the local government ***to the behavior of its users of public services / voters*** in case it receives extra grants compared to its reaction in case it had instead received extra tax autonomy –or benefited from a tax base increase- equivalent to the amount of extra grants. Hence, the strategic deficit increasing behavior in case of ***expectations*** of extra ***future*** grant funding –called a "bailout" by some researchers- (the soft budget constraint problem) is still to be distinguished from the expenditure increasing behavior in case of extra ***current*** grant funding (the flypaper effect). In fact, we are dealing with 2 different "games": the first "game" is played between the higher and the lower level government, while the second "game" is played between the lower level government and its citizens.

The soft budget effect is the deliberate attempt of SCGs to worsen their budget balance, mostly by means of expenditure increases. This worsening of the budget balance is meant to be a signal to the subsidizing government. The subsidized government expects it to generate a –discretionary- increase in its grant financing, meant to improve its budget balance and/or to prevent it from scaling back public services perceived as essential.

Although the term "bailout" is mostly used in an ex post context –i.e. on the occasion of a default-, in Belgium "bailouts" of R&Cs have so far only been ***ex ante*** (wording by Bordignon), as well as ***partial and implicit*** (wording by Sorribas-Navarro 2011 p. 154). Therefore it may seem exaggerated to use the word "bailout" within a Belgian context[26]. However, Inman (2003 p. 35 and 38-39), in his theoretical analysis

[26] Still we have come across a number of papers on fiscal federalism in Belgium using the term "bailout", i.e. Algoed e.a. (2007 p. 20), Leibfritz (2009 p. 24) and Swenden (2010 p. 10). Leibfritz uses it synonymously with the phrase "necessary solidarity measures" in the context of the extra transfers to the French Community in 1993 and in 2001. Algoed (2009a p. 4) uses the label "raid on the fiscal commons". Another exception is Spahn (2007 p. 2), who uses the notion of the Belgian R&Cs having repeatedly been "bailed ***in***" by the federal government.

of local governments' soft budget constraints, points at the blurred dividing line between extra transfers –i.e. implicit bailouts- and excessive deficit bailouts –i.e. explicit bailouts[27]. While explicit bailouts allow local governments to shift ***previous period*** budgetary costs onto nonresidents, extra transfers allow local governments to shift ***current period*** budgetary costs onto nonresidents. Likewise Bordignon and Turati (2009) argue for Italian provinces that bailouts of provincial deficits incurred because of overspending in the health sector may well have happened ***ex ante***, instead of ex post. The CG may have wished to ***prevent*** having to repay debts on which lower governments defaulted, as preventive action may in its view at least have avoided the –presumably high- spillover effects of an outright default (at least in the short term). In what follows, we will use the term "implicit bailout" to describe the respective grants increases to individual Belgian governments by means of the successive revisions of the SFA.

Another dividing line which appears difficult to draw is that between bailouts by extra ***discretionary*** grants and bailouts by extra ***non-discretionary*** grants: Sorribas-Navarro (2011) demonstrates a causal relationship from deficits towards extra "a priori"-***formula-based*** grants. In Spain, the so called PIE formula only appears non-discretionary "a priori" and appears to be able to be renegotiated between the states every 5 years. Also in Belgian fiscal federalism formula-based intergovernmental grants have appeared to be prone to change by politicians, by means of revisions of the SFA.

In what follows we will first analyse the subsequent implicit bailouts between the FG and the R&Cs in the history of Belgian fiscal federalism since 1989. Secondly we will compare the characteristics of a system of fiscal federalism which Inman (2003) identifies as conducive to "bailouts" to the Belgian fiscal federalism context. Finally we will assess the Belgian "internal stability pacts" ("Samenwerkingsakkoorden") concluded between the federal level and the R&Cs in view of keeping the overall Belgian budget deficit under control. We will try and answer the question whether they have been a worthy substitute to the institutions that are needed for hard individual budget constraints but that are missing from Belgian fiscal federalism.

[27] At least until the end of the previous century the CGs of Germany and Sweden ***explicitly*** foresaw the possibility of allocating supplementary grants to SCGs "with fiscal problems". These possibilities have probably been interpreted by the SCGs in question as a bailout promise by the CG, and in Germany this was even confirmed by the constitutional court in the mid-1980s (Rodden 2005 p. 197). Such a legal possibility has never existed in Belgium as for supplementary federal grants to one or more of the R&Cs. (However the Brussels Region has been providing such supplementary grants to its own municipalities "with fiscal problems". Ironically, as we will see, the Brussels Region itself received a considerable implicit bailout from 2013 onwards.)

4.2.An overview of the Belgian intergovernmental implicit bailouts since 1989

4.2.1.The 1993 and 2001 implicit bailouts

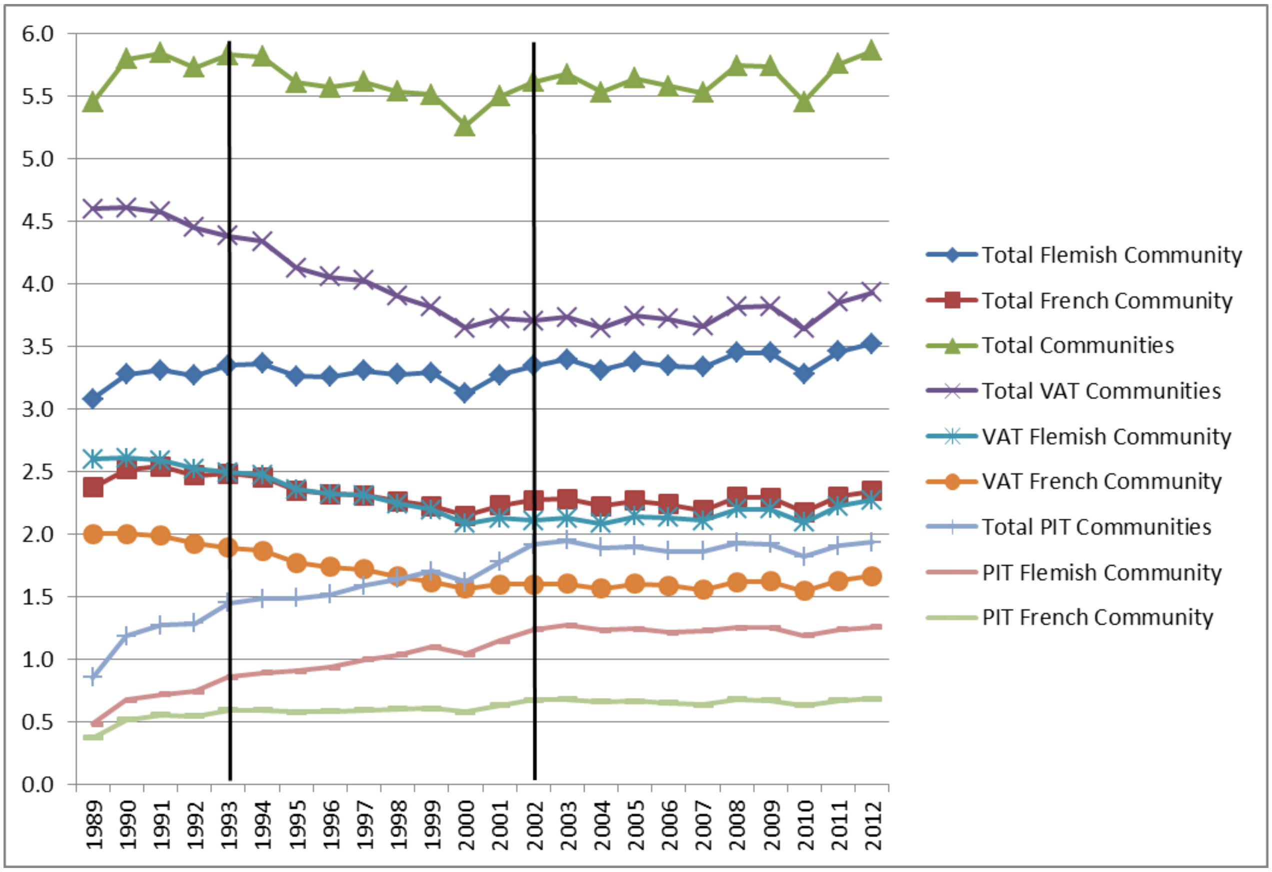
Graph 5 shows the evolution of revenues of the 2 main Belgian Communities, the Flemish and the French Community[28]. These revenues almost exclusively consist of 2 federal grants, the so called VAT grant and the so called PIT grant[29]. Their names stem from their notional funding out of the federal VAT revenues and PIT revenues respectively. They came into existence with the voting of the first SFA in 1989, which is the effective starting date of Belgium as a fiscally decentralised country –at least in terms of expenditures. This is because the R&Cs only obtained sizeable expenditure responsibilities, such as infrastructure and education, in 1989. It is important to know that in 1989 the “masterminds” of the SFA had devised the VAT grant as increasing only with inflation and not with economic growth. In this way the burden of reducing the federal deficit would be shared with the R&Cs[30]. This seems to have made sense as the SFA had left the entire public debt with the FG, while it could be argued that infrastructure, education and other expenditure responsibilities devolved to the R&Cs in 1989 had contributed to the build-up of the Belgian public debt before 1989. Moreover they would possibly ***keep*** contributing to the Belgian public debt as the bulk of those expenditures would be financed with federal transfers after 1989. Hence, graph 5 shows the VAT grant decreasing as a % of GDP throughout the 90s.

[28] For convenience, we disregard in this paper the 3rd Community, the German-speaking Community, which comprises only 0.7% of the Belgian population.

[29] A number of other –much smaller- grants to the Communities were also increased on the occasion of the 1993 and 2001 decentralisation rounds. For a more comprehensive description, see Algoed (2009a p. 3-10).

[30] There is anecdotal evidence that -shortly after they had voted the 1989 SFA into law- Francophone political parties felt “tricked into an underfunding of the French Community” by the FG –which was at the time bent on reducing the overall Belgian budget deficit.

Graph 5: VAT grants, PIT grants, and total revenues of the Communities in % of Belgian GDP



Source: FOD Financiën (and IMF for GDP data)

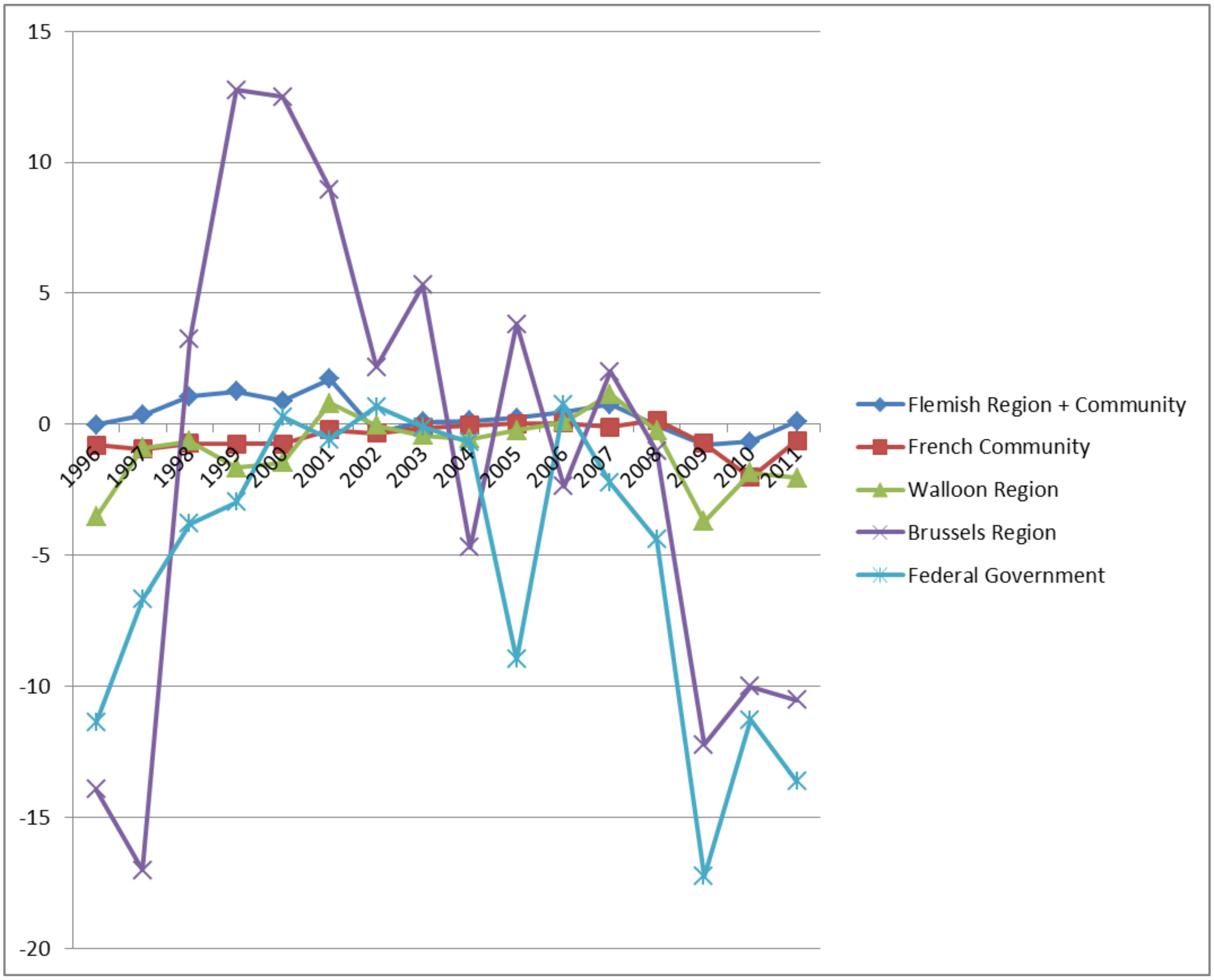
The 1993 and 2001 revisions of the major Belgian fiscal federalism law (SFA) may be considered as having included (implicit) “bail outs” of the Communities. The 1993 and 2001 revisions included extra grants mainly in view of increasing education expenditures of the French Community, after it had run successive –albeit limited- deficits (see graph 6[31]). These revisions can be considered cases of logrolling[32]: the extra transfers they entailed –importantly coming ***without*** extra expenditure responsibilities- were requested by the French Community and the Francophone political parties and were matched by the devolution of limited extra expenditure responsibilities (1993) and considerable extra tax autonomy (2001) from the federal state, demanded by the Flemish R&C and Flemish political parties (also see Swenden 2010 and Blöchliger and Vammalle 2012). These requests for extra grants can be considered paradoxes as the French Community has benefited from more revenues per capita than

[31] Budget balances in graph 6 are expressed as a share of the total revenues of the individual governments concerned (with subcentral transfers subtracted from the revenue of the federal government). These relative budget balances enable a comparison of budget balances across Belgian governments. It shows that the FG and the Brussels Region have run by far the largest relative deficits over the period considered, in particular at the beginning and at the end of the period for which we have found data. Unfortunately we have not found budget balance data for the R&Cs for the years 1989 until 1995.

[32] Logrolling or bundling is an exchange of votes between 2 different parties in a legislative process.

the Flemish Community ever since the voting of the SFA[33]. Logrolling explains why the hurdle of a 2/3 majority in the federal parliament –to be complemented by a 50%+1 majority in both language groups in the federal parliament- for any revision of the SFA has already been taken a number of times in Belgium.

Graph 6: Fiscal balances of Belgian governments as a share of their respective revenues (%)



Source: INR and FOD Financiën

[33] This paradox is partly explained by the merger between the Flemish Community and the Flemish Region immediately after the R&Cs came into existence. This merger made considerable subsidies from the Flemish Region to the Flemish Community possible, i.e. the shifting of financial means meant for investment spending (road infrastructure and the like being an Regional responsibility) to recurrent spending (teachers' salaries, being a Community responsibility). One Flemish minister famously argued in this respect that "cobblestones don't go on strike".
A similar merger between the French Community and the Walloon Region appeared not feasible, i.a. because while about 95% of the Flemings live in the Flemish Region, only some 80% of the Belgian Francophones live in the Walloon Region.

Moreover both revisions were of a “one-size-fits-all” nature: also Flanders obtained the extra grants requested by Francophone Belgium, and also Francophone Belgium obtained the increase in expenditure responsibilities and tax autonomy requested by Flanders. This contrasts with the asymmetric decentralisation rounds that countries such as Canada and Spain have witnessed. It is therefore ironic that the various Belgian SFA revisions have “re-imported Belgian waffle-iron policy through the back door”. “Waffle-iron policy” is the Belgian variant to logrolling, and usually refers to the Belgian unitary investment policy of the past, under which a project in favour of one language community had to be matched with a similar sized –or often even identical- project for the other language community. The irony is that the Flemish autonomy movement precisely wished to ***avoid*** such expensive “waffle-iron policy” or at least scale it back ***by decentralizing*** the unitary Belgian state. While “specific” waffle-iron policies had mostly been done away with thanks to the 1989 reform, instead Belgium was confronted with “general” waffle-iron policy from 1993 onwards.

Because of their one-size-fits-all nature and because they concerned ***general purpose*** grants, the 1993 and 2001 SFA revisions are only partly reminiscent of the “omnibus projects” analysed in the American distributive politics literature in the spirit of the “Law of 1/n” as demonstrated by Weingast e.a. (1981). The US Congress regularly votes with an overwhelming majority in favour of large spending bills containing a hotchpotch of ***earmarked*** grants and favouring almost every state. Weingast e.a. (1981) demonstrate that such bills lead to an oversized and inefficient local public sector at the expense of the average federal taxpayer.

4.2.1.1.The 1993 implicit bailout

In spite of the design of the 1989 SFA, the R&Cs already quite soon obtained a reduction of their share in the federal deficit reduction burden. Graph 5 shows the impact of the revision of the SFA in 1993 (marked with a vertical bar): a –rather sudden- extra increase of the PIT grants between 1992 and 1993 (which came in the form of a –one-off- lump sum increase of the “base PIT grant”), as well as –rather gradual- increases of the PIT grants after 1993 (which came in the form of the “base PIT grant” gradually becoming fully tied to economic growth)[34]. Hence, the 1993 implicit bailout was not only implicit, but also partial, because of its gradual nature. The 1993 implicit bailout caused an even greater share of the deficit reduction effort in view of Euro-accession to be effectively borne by the FG (shown by the bottom curve of graph 1)[35].

Table 1 shows that the extra PIT grant to the Communities increased from 0.06% of GDP in 1993 to 0.17% of GDP in 2000 –the year from which the PIT grant was fully tied to economic growth (as was already stipulated in the original SFA). It increased the Communities’ total revenue by 1.1% in 1993, which continued to increase to 3.3% in 2000.

[34] It is paradoxical that while it was the VAT grant to the Communities that had been designed to decrease as a % of GDP, the 1993 implicit bailout consisted of a topping up of the PIT grant, which was already increasing as a share of GDP before 1993 (see graph 5). This original increase of the PIT grant as a % of GDP was due to the PIT grant having been originally designed as annually increasing with inflation as well as with a lump sum amount.

[35] However, to some observers the 1993 extra grants were not so much an implicit bailout as an “inevitable and badly needed re-financing” of the Communities, as also for the Flemish Community the evolution of its major VAT grant with inflation only would soon have become “untenable”.

Table 1: The budgetary impact of the 1993 and 2001 SFA revisions on the Communities

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
1993 extra PIT grant to the Communities (% GDP)	0.06	0.06	0.06	0.07	0.10	0.12	0.17	0.17	0.17	0.16	0.16	0.16	0.16	0.15	0.15	0.15	0.15	0.14	0.14	0.14
1993 extra PIT grant to the Flemish Community (% GDP)	0.04	0.04	0.04	0.04	0.07	0.08	0.11	0.11	0.11	0.11	0.11	0.10	0.10	0.10	0.10	0.10	0.09	0.09	0.09	0.09
1993 extra PIT grant to the French Community (% GDP)	0.02	0.02	0.02	0.02	0.04	0.04	0.06	0.06	0.06	0.06	0.06	0.06	0.06	0.05	0.05	0.05	0.05	0.05	0.05	0.05
1993 extra PIT grant (% increase in Community budgets)	1.05	1.08	1.14	1.24	1.87	2.25	3.22	3.31	3.13	3.02	2.97	2.98	2.86	2.82	2.78	2.65	2.62	2.70	2.50	2.41
2001 extra VAT grant to the Communities (% GDP)										0.07	0.13	0.17	0.30	0.33	0.41	0.45	0.38	0.54	0.56	0.59
2001 extra VAT grant to the Flemish Community (% GDP)										0.04	0.08	0.11	0.18	0.20	0.25	0.28	0.24	0.34	0.36	0.38
2001 extra VAT grant to the French Community (% GDP)										0.03	0.05	0.07	0.12	0.13	0.16	0.17	0.15	0.21	0.20	0.21
2001 extra VAT grant (% increase in Community budgets)										1.33	2.30	3.26	5.53	6.28	8.05	8.59	7.18	11.00	10.87	11.28
Total extra 1993 and 2001 grants to the Communities (% GDP)	**0.06**	**0.06**	**0.06**	**0.07**	**0.10**	**0.12**	**0.17**	**0.17**	**0.17**	**0.24**	**0.29**	**0.33**	**0.45**	**0.48**	**0.56**	**0.60**	**0.53**	**0.68**	**0.70**	**0.73**
2001 extra tax autonomy for the Regions (% GDP)										1.09	1.14	1.22	1.45	1.53	1.52	1.45	1.35	1.44	1.15	1.15
2001 extra tax autonomy (% increase in Regions' budgets*)										27.24	27.53	30.23	35.36	37.92	37.25	34.45	32.12	35.64	30.11	29.15

*budget increase ***before*** partial compensating reduction of the Regions' PIT grant

Sources: FOD Financiën (and IMF for GDP data)

Table 1 also makes clear that although it was the French Community that requested the extra grants, it was the Flemish Community that received the most of them. That this was the case in absolute terms is not surprising, as the Flemish Community is considerably larger than the French Community. But this was also the case in relative terms, i.e. compared with the Flemish share in the extra grants to the ***Flemish share in federal tax revenue***, out of which the extra grants were financed. Hence, the Flemish political parties not only requested that also the Flemish Community would be bailed out –in spite of the absence of any pressing need for this. They also requested that their implicit bailout would start "repairing" the fact that by virtue of the SFA the Flemish Region/Community was the ***least funded*** of the Belgian R&Cs on a per capita basis, while it ***contributed the most*** to federal tax revenues on a per capita basis[36]. As the shares of the Belgian Region in federal tax revenues are hard to calculate, by means of illustration we only show these shares for the years 2007-2009 in table 2, years for which these shares are available.

The sharing of the extra PIT grant provided in 1993 was advantageous for Flanders because it was shared between the Communities in the same way as the "base" PIT grant was shared, i.e. according to the ***shares of the Communities in federal PIT revenue***. Because the PIT grant should be considered as being financed out of the entirety of federal tax revenues –instead of out of PIT revenues in particular[37]-, a sharing of the PIT grant between the Communities according to the Communities' shares in federal PIT revenues is advantageous to the Flemish Community. This is because the share of the Flemish Community in federal ***PIT*** revenue is higher than the share of the Flemish Community in ***overall*** federal tax revenue (see table 2 as an illustration for the years 2007-2009).

Table 2: Regional shares in Belgian population, total federal tax revenue and federal PIT revenue

	2007	**2007**	**2007**	**2008**	**2008**	**2008**	**2009**	**2009**	**2009**
	Population	**Total taxes**	**PIT**	**Population**	**Total taxes**	**PIT**	**Population**	**Total taxes**	**PIT**
Flemish Region	57.8	60.6	63.3	57.8	60.2	63.1	57.7	60.0	62.5
Walloon Region	32.5	29.1	28.3	32.4	29.5	28.5	32.3	30.2	29.0
Brussels Region	9.7	10.3	8.4	9.8	10.4	8.4	9.9	9.8	8.5
Total	100	100	100	100	100	100	100	100	100

Source: Vives 2012 p. 33 and Statbel

[36] In the Flemish literature on Belgian fiscal federalism, the combination of these facts is labeled the "revenue paradox".

[37] The label "PIT grant" is hence misleading.

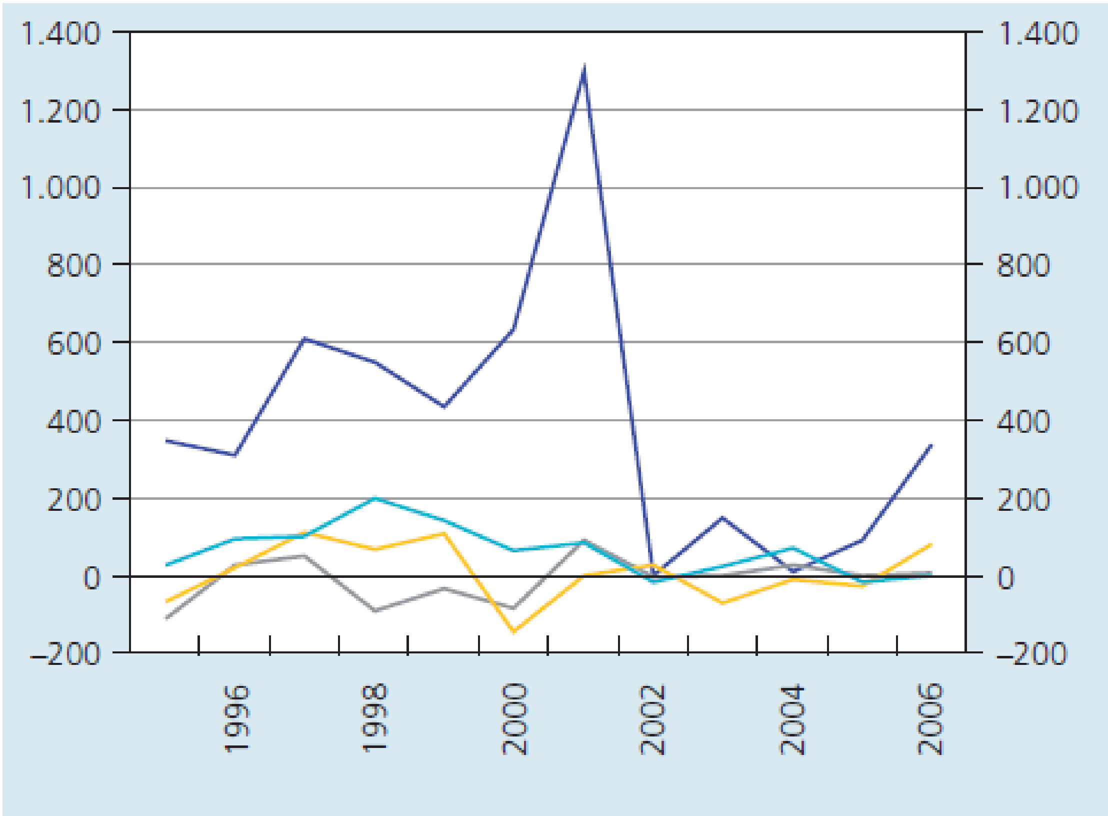
4.2.1.2.The 2001 implicit bailout

Even after -but according to the soft budget constraint hypothesis rather ***because of***- the extra grants of 1993, the French Community continued to run repeated deficits (see graph 6), continued its debt accumulation (see graph 9), and repeatedly missed its deficit targets imposed by the Belgian "Internal Stability Pact". (see graph 7, taken from Van Meensel and Dury 2008 p. 79) As a consequence, in 2001 the SFA was revised once again to be able to accommodate extra grants to the French Community, this time by means of a revision of the VAT grant. The impact of the 2001 SFA revision (equally marked with a vertical bar) is even more noticeable from graph 5 and table 1 than the impact of the 1993 SFA revision. While the VAT grant had already effectively been stabilized as a % of GDP from 2000 onwards – as the year 2001 showed weak economic growth-, the 2001 SFA revision ensured that this stabilization would continue when economic growth resumed in 2002. The 2001 SFA revision even caused the VAT grant to increase as a % of GDP from 2008 onwards. This increase from 2008 onwards was because the extra VAT grant consisted of 2 components: an immediate -and until and including 2007 strongly increasing- lump sum increase of the "base VAT grant", and a tying of the total VAT grant to 91% of economic growth from 2007 onwards. As a consequence the extra VAT grant to the Communities increased from 0.07% of GDP in 2001 to 0.59% of GDP in 2012. It increased total revenue of the Communities by 1.3% in 2001, a % that continued to increase to 11.3% in 2012.

Again the Flemish political parties negotiated a distribution of the federal extra grants that was advantageous to the Flemish Community. Again they were motivated by their desire to reduce the gap between the tax revenues per capita contributed by Flanders to the federal coffers and the grants per capita allocated by virtue of the SFA to the Flemish Community/Region. This distribution of the 2001 federal extra grants is advantageous due to the gradually increasing sharing of the 2001 extra VAT grants between the Communities according to the ***Communities' share in federal PIT revenue***. The extra grants were shared in a way which would over time increasingly differ from the way the "base" VAT grant is shared between the Communities, i.e. according to the ***shares of the Communities in the 6 to 17 year old Belgian population***. Because the VAT grant should be considered as being financed out of the entirety of federal tax revenues –instead of out of revenues of the Value Added Tax (VAT) in particular-[38], a sharing of the VAT grant between the Communities according to the Communities' shares in federal PIT revenues is advantageous to the Flemish Community. This is because the share of the Flemish Community in federal PIT revenue superseded the share of the Flemish Community in overall federal tax revenue to an even larger extent after 2001 than for the majority of the years since 1993 (see table 2 for an illustration for a number of years after 2001).

[38] The label "VAT grant" is hence misleading.

Graph 7: Deviation of actual fiscal balances of R&Cs from agreed fiscal balances (in million euros)



Note:

Dark blue: Flemish Region/Community

Light blue: Brussels Region

Yellow: Walloon Region

Grey: Francophone Community

Source: Van Meensel and Dury 2008 p. 79

However, to be able to assess the effect of the 2001 reform on the overall Belgian budget balance in a more comprehensive manner, the extra tax autonomy obtained by Flanders on the occasion of the 2001 reform also has to be considered, as the empirical fiscal federalism literature has found beneficial overall fiscal effects of an increase in subcentral tax autonomy (see above). Table 1 shows that the 2001 increase in tax autonomy amounted to more than twice the extra grants since 2001 as a % of GDP (see last row in table 1). Moreover an increase in subcentral tax autonomy seems even more permanent in nature than a grants increase, as in Belgium an increase in subcentral tax autonomy has hardly ever been scaled back, while from 2014 onwards, the 1993 and 2001 extra grants to the Communities ***will*** effectively be scaled back (see below) [39].

However, extra grants and tax autonomy are hard to compare, even when expressed as a % of GDP:

- their respective fiscal impacts on the FG and on the SCGs after the 2001 reform were entirely different: the extra tax autonomy was largely compensated by a parallel reduction in the PIT grant to the Regions[40];
- it is difficult to estimate the extent to which the expected increase in subcentral fiscal discipline thanks to the increased tax autonomy has effectively compensated the expected decrease in subcentral fiscal discipline due to the increased grants (also see the discussion of graph 4 above)[41]

A cause for caution with respect to the effect on fiscal discipline is that notwithstanding the increase in tax autonomy thanks to the 2001 reform, the Belgian VFG hardly decreased and remained high when compared internationally (see graph 2a and b). Despite the corresponding increase in tax autonomy, the 2001 SFA reform may even be considered more harmful for the overall Belgian fiscal balance than the 1993 SFA reform, as the top curve in graph 4 (see above) shows that the overall revenue of the Communities kept ***decreasing*** in spite of the 1993 implicit bailout, but that it on average ***increased*** on an annual basis after the 2001 implicit bailout.

[39] Hence, from a reform perspective the 1993 implicit bailout looks odd as it was not conditioned on more tax autonomy by the Flemish parties. Reform-wise, the 1993 implicit bailout could therefore be considered "useless", as it was not tied to changes in the Belgian fiscal federal system. (In comparison, in Spain extra discretionary grants have been used to make some Regions accept fundamental changes in the way –decentralised- Spanish health care is financed, as described by Sorribas-Navarro (2011 p. 167).)
[40] The PIT grant to the Regions is not shown in graph 5.
[41] Still, the increase in tax autonomy implemented by the 2001 SFA revision has been so considerable that the following OECD (2012 p. 20) finding seems ***not*** to apply to the 2001 SFA revision: "Bundling often ends up with the CG "buying" the support of opponents of reform. Although some additional transfers could be justified (…) fiscal relations reforms {i.e. more tax autonomy in the case of the 2001 SFA revision} are often too costly for the CG {in terms of the needed compensatory extra transfers}".

4.2.2.The 2013 implicit bailout

4.2.2.1.The 2013 implicit bailout of the Brussels Region

A first feature of the 2013 decentralisation round within the context of the soft budget effect is that it comprises important extra grants for the Brussels Region. The 2013 extra grants will increase to 0.1% of Belgian GDP per year in 2017[42], the year from which the extra grants will start to decrease somewhat as they are not fully tied to economic growth. The extra grants will increase total revenue of the Brussels Region to about 0.95% of Belgian GDP per year (i.e. the extra grants will increase total revenue of the Brussels Region by more than 10% compared to the previous SFA). These extra grants will be provided after repeated budget deficits were incurred by the Brussels Region (see graph 6). This was in spite of considerable increases in revenues after the 2001 decentralisation round (see also graph 5). These in turn were mostly attributed to the devolution of Belgian real estate taxes to the Regions which this decentralisation round provided, combined with the flourishing Brussels real estate market during the beginning of the previous decade. As a consequence, the Brussels Region has been the most heavily financed of the 3 Belgian Regions on a per capita basis (see Algoed 2009b; see table p. 13 in Leibfritz 2009).

However, the Brussels Region continued to communicate that its fiscal situation was dire, as it would increasingly suffer from negative spillover effects exerted by the other 2 Belgian Regions and the FG (e.g. transport of commuters and federal immigration policy) as well as exert positive spillover effects on the other Belgian Regions through the public goods it provides as capital and largest city of Belgium. In 2010 its finance minister commissioned a study that estimated that in previous years Brussels had missed revenues and made expenditures to the combined annual amount of 720 million euros due to its multiple statuses of 1) capital 2) city 3) state (Verdonck e.a. 2010). On the basis of this study the Brussels finance minister stated that the Brussels Region would not balance its budget before it would be "re-financed" by the FG (see Vanraes 2010). A parallel can be drawn between the Brussels 2013 extra grants and the Bremen and Saarland 1992 bailout: after fiscal equalization they were the most favourably financed per capita of the German Länder, but were still bailed out by the German FG in 1992, with extra grants being allocated from 1994 until 2004. However, they continued to show among the highest per capita expenditure growth, debt and deficits of all Länder, and they argued that the bailouts received were insufficient (Rodden 2005 p. 196 and 393)[43].

[42] This amount dwarfs the other federal grants increases specifically in favour of the Brussels Region since the voting of the original SFA in 1989. Most have not been allocated on the occasion of an SFA revision, e.g. increases of the federal Beliris fund for Brussels infrastructure and increases in Brussels police financing. Some were allocated on the occasion of the 2001 SFA revision, e.g. an extra federal subsidy to Brussels municipalities conditioned on the inclusion of a politician of a Dutch-speaking political party into its government.

[43] Also to be compared to the unsuccessful request for a bailout by the capital city of Berlin in 2006, whose fiscal situation was not considered urgent enough by the German Constitutional Court. (FAZ 2006)

Not only does the 2013 Brussels implicit bailout seem sizeable in financial terms, it was also unconditional[44]. On the contrary, the Brussels Region will increase its –tax and expenditure- autonomy even more than the 2 other Regions thanks to the 2013 decentralisation round . It is interesting to compare the extra annual transfers to Brussels voted in 2013 to the 600-million-dollar-per-year bailout Washington DC received in 1997, which caused local politicians to lose control over important public services to a federally appointed control board (Inman 2003 p. 60). It should be noted however that the 2013 Brussels implicit bailout should be seen as another case of logrolling: an –overwhelming- majority within the Francophone group in the federal parliament obtained the Brussels implicit bailout in return for the request of a –small- majority within the Flemish group in the federal parliament to split up the federal electoral district of Brussels-Halle-Vilvoorde –the only electoral district straddling 2 Belgian Regions- into Brussels and Halle-Vilvoorde, a request that as such is hard to relate to Belgian fiscal federalism.

[44] The Brussels Region has been formally obliged to simplify its government institutions, but the Brussels Region itself would be fully in charge of this simplification task.

4.2.2.2.The 2013 implicit bailout of the federal government

A second feature of the 2013 decentralisation round within the context of the soft budget effect is that it comprises important “extra grants” for the FG. Indeed, the other “winner” of the 2013 SFA revision in net financial terms –next to the Brussels Region- appears to be the FG[45]. (see Jennes 2013 and Decoster and Sas 2013 for calculations of the fiscal effects of the 2013 revision of the SFA) 2 changes to the SFA account for the beneficial effect of the 2013 SFA reform on the FG. From 2014 onwards 1) a number of existing SFA grants to R&Cs will be reduced and 2) a transfer from the R&Cs to the FG in view of the payment of the pensions of the R&Cs’ employees will be established[46]. Hence, the 2013 round comprises a number of measures which can be considered the first re-centralisation in the Belgian history of fiscal federalism[47]. These have been motivated by the fact that in Belgium the FG is almost alone in bearing the costs of ageing. Indeed, the federal level is almost the only level in charge of health and pension expenditures, which have increased strongly since a number of years.

However, as increasing costs of ageing had been forecast in Belgium for many years, these can hardly be considered a calamity, without going so far as to claim that the majority of these costs would be avoidable. In this perspective, the federal inaction to mitigate these cost increases since Belgium acceded to the Euro-zone could be considered a case of moral hazard[48]. Therefore, a devolution of ageing-related spending to the R&Cs may have been a more incentive-compatible response to the apparent inability of the federal level to keep it under control. This measure was suggested in IMF (2008 p. 20) and OECD (2013 p. 23), but it is only hesitantly put into practice by the 2013 revision of the SFA.

[45] Remarkably though, the FG coalition stated that the R&Cs will be the “winners” of the 2013 SFA revision. This is because the FG coalition assumes that PIT revenue will increase much more strongly than GDP -50% more strongly- over the next 20 years. Hence, it probably overestimates the Regions’ fiscal benefits of the 2013 devolution of part of the PIT to the Regions, as well as its fiscal loss to the FG. Another way of stating this is that the FG de facto obliged the R&Cs to let the tax burden increase to be able to come out as a “winner” of the 2013 SFA revision. (see also Frogneux and Saintrain 2013 p. 14-15)

[46] Still, there is a 3rd way in which the 2013 SFA revision shifts deficit reduction efforts towards the R&Cs. As stated above, it also transfers some –non-core- expenditure responsibilities in the field of ageing towards the Communities. However this is being done without transferring 100% of the means the FG was using to fund them, similarly to the 1989 decentralisation round. The latter way of shifting deficit reduction efforts seems to be the most incentive-compatible way of the 3 ways that are being used, because the empirical literature on decentralisation suggests that overall, decentralized implementation of expenditures is more efficient, and hence less costly (at least if it goes with an increase in tax autonomy).

[47] While –possibly as importantly for Belgian fiscal decentralisation as such- the 2013 SFA revision comprised devolution of important expenditure categories as well as part of the PIT to the R&Cs (see last 2 rows of table 3).

[48] However, the official Belgian strategy since Belgium’s accession to the Euro has always been to mitigate ageing costs by running overall budget surpluses. OECD (2010 p. 10) is among the many observers to note that “prefunding {of costs of ageing} strategies from Belgium’s Stability Programmes have never materialized {between 2000 and 2010}”. Graph 10 below showed that over the previous decade the actual overall budget balance has always fallen short of the overall surpluses targeted by the HRF. On a related note, the share of social expenditures in Belgian GDP is among the highest of all OECD countries. The effective retirement age and participation rates are among the lowest.

Only child benefits, a part of health care, and care for the elderly will be devolved to the Communities[49] (see last row of table 3), with the FG retaining some regulatory competencies with respect to the 3 newly decentralized expenditure categories. As a last resort, the FG could fund part of the cost increases concerned with own expenditure decreases elsewhere or own tax increases, rather than to "shift the bill" to other Belgian governments.

Hence, the 2013 revision of the SFA could be considered a "reverse implicit bailout", i.e. an implicit bailout of the FG by the R&Cs[50]. This implicit bailout is estimated to amount to 0.59% of GDP in 2016 (see 5th row of table 3), increasing the total revenue of the FG with an estimated 2.2% compared to what it would have been without the implicit bailout. The amount of the implicit bailout will gradually increase to 0.86% of GDP by 2030 –increasing the total revenue of the FG with an estimated 3.2%[51]. This reverse transfer will largely be paid by the Flemish Region/Community, amounting to 0.41% of GDP in 2016, and decreasing the total revenue of the Flemish Region/Community with an estimated 4.5%. The share of the Flemish Region/Community in the federal implicit bailout will increase to 0.65% of GDP in 2030 –decreasing the total revenue of the Flemish Region & Community with an estimated 7.1%. The 2013 revision of the SFA appears to generate fewer losses for the French Community and the Walloon Region –which, when taken together[52], finance the FG to the amount of 0.26% of GDP in 2016. The total revenue of the French Community and the Walloon Region will decrease with an estimated 4.6%. The share of the French Community and the Walloon Region in the federal implicit bailout will increase to 0.31% of GDP in 2030 –decreasing total revenue of the French Community and the Walloon Region with an estimated 5.7%[53].

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[49] Hence, for the first time in Belgium, SCGs have obtained responsibility over a part of social security, while this is already the case for many years in most other decentralized OECD countries (see e.g. Boadway and Shah 2009 p. 395-417).

[50] The wording "reverse implicit bailout" is appropriate here, because existing federal transfers will be reduced without changing the expenditure responsibilities these transfers are meant to finance. The wording is less appropriate to describe the transfer of new expenditure responsibilities to the R&Cs without transferring 100% of the federal financing that the FG devoted to these expenditure responsibilities.

[51] This is including the extra cuts in federal grants to the R&Cs decided during the finalizing negotiations in the Summer of 2013.

[52] Our motivation for adding up the French Community and the Walloon Region is that about 80% of the citizens belonging to the French Community live in the Walloon Region, and both SCGs have been governed by the same set of –Francophone- political parties.

[53] This reverse implicit bailout could be compared –as for its nature, not as for its size- to the shifting of part of the costs of German reunification by the German FG to the old Länder, although the German reunification seems more of an exogenous shock than an ageing population. Hence it seems harder to mitigate the costs of an unexpected shock like reunification than the costs of population ageing.

The 2013 implicit bailout can also be compared to the reduction of federal transfers to the Canadian provinces under Minister of Finance Paul Martin in the 90s, as part of his –successful- effort to bring under control the high overall Canadian budget deficit and public debt. The difference with Belgium here is that the beneficial effect of the Belgian transfer cuts on the Belgian overall budget balance are still to be proven, as the FG could use the transfer cuts for other purposes than to reduce its own budget deficit.

Apart from the classical "vertical" implicit bailouts and the 2013 "reverse" implicit bailouts, "horizontal" implicit bailouts seem to occur within Belgian fiscal federalism. See footnote 3 above about cross-subsidization between the budgets of the Flemish Community and Region, as well as between the budgets –and between the deficit

Hence the 2013 revision of the SFA could be considered as an operation in which the R&Cs –except the Brussels Region- will annually “pay back” to the FG the extra funding the R&Cs received because of the 1993 and 2001 revisions of the SFA, plus interest charges (compare percentages in tables 1 and 3). The net cut in federal grants to the R&Cs is considerable, in particular when expressed relative to R&Cs’ total expenditures. Additionally, the bulk of the net transfer cut was decided only during the finalizing SFA negotiations in the Summer of 2013, while it will already come into effect in 2015. Therefore, it is expected to hamper fiscal management of the R&Cs, and therefore fiscal discipline.

The percentages by which federal transfers to the R&Cs will be cut on a net basis are broadly in line with the 2010 recommendation of the Federal Planning Bureau (Saintrain 2010) and of the HRF (2013a) that Entity I would “transfer part of its fiscal sustainability gap” to Entity II[54], “so that the relative sustainability gap of the FG –i.e. compared to its share in federal expenditures- would not increase” (Frogneux and Saintrain 2013 p. 6). Saintrain (2010 p. 2-3) defines the FG’s fiscal sustainability gap as the FG’s primary fiscal deficit when including implicit liabilities of the FG due to population ageing, and estimates it to amount to no less than 6.3% of GDP in 2015. Nevertheless the net transfer cuts’ estimated favourable effect on the federal budget will not suffice to solve the chronic fiscal problems of the Belgian FG, so once again the term bailout applies only partially.

reduction efforts (see e.g. HRF 2013b p. 100-104)- of the 3 (predominantly) Francophone Regions and Communities.

Similarly, at the federal level, the FG has been anxious in recent years to provide additional and increasing transfers to the Belgian social security system, so as to ensure that this system is running a “balanced budget”. Even in the years after 2008, when the economic crisis started, Belgian social security has more or less been able to balance its books. These horizontal implicit bailouts of social security are puzzling from a political economics perspective, in particular when assuming that they would have been funded with extra borrowing, i.e. when assuming that they would not have crowded out other federal expenditures than social security expenditures. This is because while on a net basis Flanders benefits relatively less from federal social security expenditures as well as from other federal expenditures than Francophone Belgium (see e.g. Vives 2012 p. 45), Flemish political parties that are part of the federal coalition apparently have agreed to such implicit bailouts, as well as to the social security expenditure increases of the past that have provoked the successive implicit social security bailouts.

[54] “Entity II” is the Belgian label for its SCGs, while “Entity I” comprises the FG (including social security).

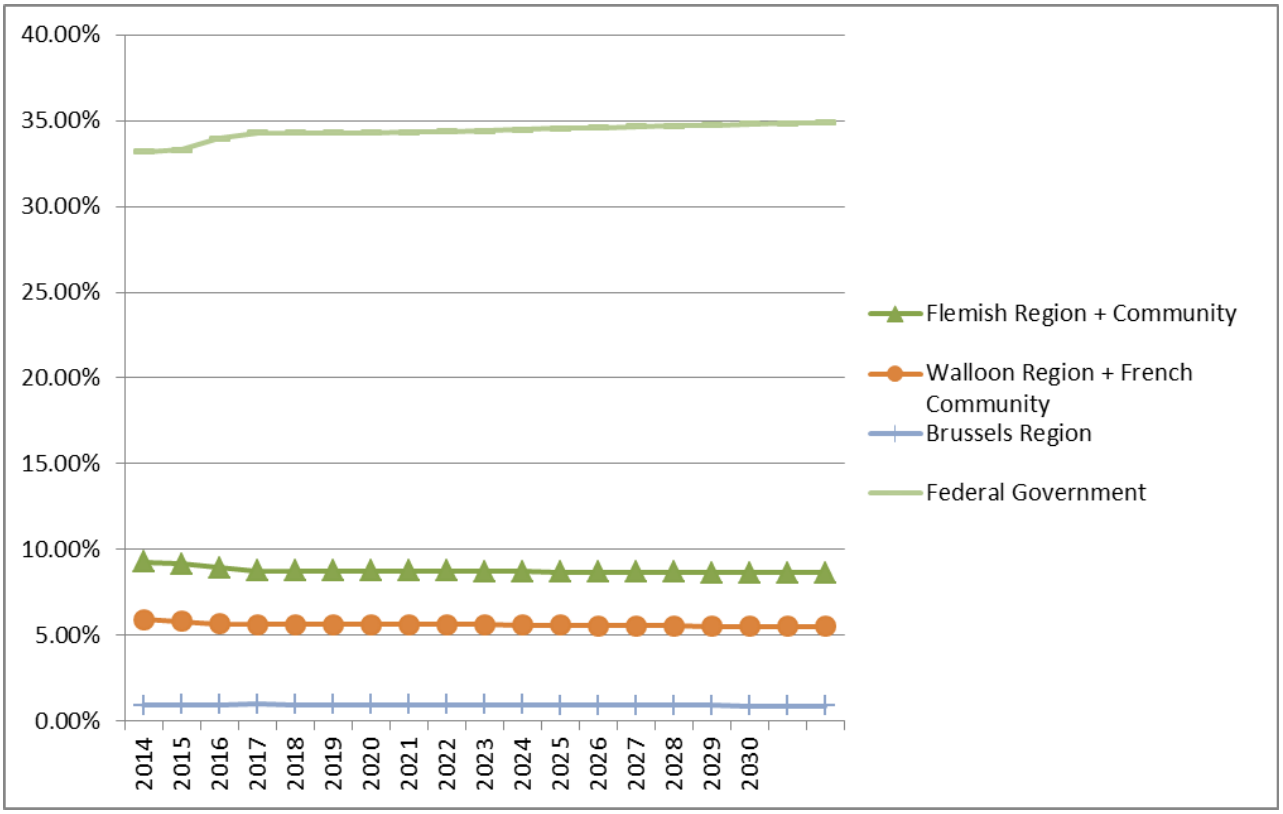
Table 3: The budgetary impact of the 2013 SFA revision on the Belgian governments (% GDP)

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028	2029	2030
Extra grants Flemish Region+Community	0.00%	-0.17%	-0.41%	-0.44%	-0.45%	-0.47%	-0.48%	-0.49%	-0.50%	-0.52%	-0.53%	-0.54%	-0.56%	-0.57%	-0.58%	-0.60%	-0.61%
Extra grants Walloon Region+ French Community	0.00%	-0.11%	-0.26%	-0.28%	-0.27%	-0.27%	-0.27%	-0.27%	-0.27%	-0.27%	-0.28%	-0.29%	-0.30%	-0.30%	-0.31%	-0.31%	-0.31%
Extra grants Brussels Region	0.04%	0.06%	0.08%	0.10%	0.10%	0.10%	0.09%	0.09%	0.09%	0.09%	0.08%	0.08%	0.08%	0.07%	0.07%	0.07%	0.07%
Extra grants Federal Government	-0.04%	0.23%	0.59%	0.61%	0.63%	0.64%	0.66%	0.68%	0.69%	0.70%	0.73%	0.75%	0.78%	0.80%	0.82%	0.84%	0.86%
Total extra grants Brussels + Federal Government	**0.00%**	**0.28%**	**0.67%**	**0.72%**	**0.73%**	**0.74%**	**0.75%**	**0.77%**	**0.78%**	**0.79%**	**0.81%**	**0.83%**	**0.85%**	**0.87%**	**0.89%**	**0.91%**	**0.93%**
Extra tax autonomy for the Regions	2.86%	2.86%	2.87%	2.88%	2.89%	2.90%	2.91%	2.92%	2.92%	2.93%	2.94%	2.95%	2.96%	2.97%	2.98%	2.99%	3.00%
Expenditures devolved from the Federal Government	4.41%	4.45%	4.43%	4.40%	4.38%	4.36%	4.33%	4.31%	4.28%	4.25%	4.21%	4.18%	4.16%	4.14%	4.12%	4.12%	4.11%

Source: own calculations; Jennes (2013)

Graph 8 shows that –when including the impact of the 2013 SFA reform- FG revenues are projected to increase, while among the SCGs, only those of the Brussels Region are projected to remain stable as a % of GDP.

Graph 8: Estimated revenues of Belgian governments after the 2013 SFA revision (as % of Belgian GDP)



Note: FG revenues ***after*** transfers to SCGs

Source: own calculations; Jennes 2013

Remarkably, multilateral fiscal watchdogs neither seem to acknowledge the possible materializing of moral hazard because of the 2013 SFA revision, nor the fact that this revision does not address the high VFG in Belgium as a potential sources of its overall fiscal problems. E.g., IMF (2008 p. 20), OECD (2011 p. 41) and OECD (2013 p. 23) respectively have called for (i.a.) "more sharing of the adjustment burden by Entity II" and a "rebalancing of revenue streams towards the federal government". Leibfritz/OECD (2009) is somewhat more careful in his recommendations, stating both that more emphasis needs to be put on structural reform of the pension system (p. 8) and that the revenue base of the FG has to be improved by a reduction in the federal transfer amount to the R&Cs (p. 20).

4.2.2.3.Conclusion on the 2013 implicit bailouts

We expect the 2013 implicit bailout of the FG and the Brussels Region to affect the overall Belgian budget balance negatively. Admittedly, empirical evidence exists that a reduction in grants to SCGs is a helpful ingredient of achieving overall fiscal consolidation[55] (quoted in Blöchliger 2013 p. 23-24). However, the reduction of federal grants to the Belgian R&Cs decided in 2013 could be considered as a de facto reward of past FG budget deficits. Additionally, it could simply allow the FG to postpone once again its own fiscal consolidation efforts. This risk seems considerable, given the relatively poor track record of the FG over the previous decade in meeting its deficit reduction targets (also see graph 10 below). Also, the R&Cs will possibly react to the net transfer cut imposed on them by increasing their budget deficits. This is because they may perceive the 2013 SFA revision as an attempt to pass on to ***them*** the task to cut back on expenditure categories that had always belonged to the responsibility of the ***FG***[56]. Another reason for the R&Cs possibly reacting to their net transfer cut by increasing their budget deficits is that they may speculate on once more an implicit bailout in the future, given the grants-based nature of Belgian fiscal federalism.

Similarly, the increase in federal grants to the Brussels Region could be considered as a de facto reward of the budget deficits of the Brussels Region. Apart from the direct extra burden this increase puts on the budget of the FG, it does not give an incentive to the Brussels Region to reduce its budget deficit[57].

Moreover, despite the cut in existing grants to the R&Cs, the 2013 SFA reform taken as a whole will increase the VFG between the FG and the R&Cs on a net basis. This is because -as opposed to the 2001 SFA revision- the 2013 SFA revision increases the expenditure responsibilities of the R&Cs even more than their tax autonomy (see last 2 rows of table 3). The Flemish political parties managed to devolve a number of sizeable federal expenditure responsibilities towards the R&Cs, together amounting to more than 4% of GDP[58]. All of these new expenditure responsibilities will be funded with new federal grants. Hence, on balance the 2013 SFA reform does not succeed in transforming Belgium from a grants-based system of fiscal federalism to a tax autonomy based system of fiscal federalism, and hence foregoes the extra increase in fiscal discipline that such a transformation could generate.

However, as in the case of the 2001 SFA revision, to assess the overall effect of the 2013 reform on the overall Belgian budget balance, the extra transfers to some of Belgium's governments have to be

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[55] Blöchliger (2013 p. 24) points to the flypaper effect as a possible explanation: a cut in grants to SCGs reduces the extent to which SCGs are grants-funded. The expenditure reduction that such a decrease in the VFG is expected to generate, as such implies an improvement of the overall fiscal balance.

[56] Of course, as an alternative, the R&Cs are free to cut back on their existing expenditure responsibilities, instead of on their newly acquired ones.

[57] The only Francophone political party that voted against the 2013 implicit bailouts in the federal parliament did so because it considered the extra federal grants for the Brussels Region insufficient compared to the 720 million euros extra grants recommended by the study by Verdonck e.a. (2010).

[58] Of course, similar to the 2001 SFA revision, the 2013 increase in tax autonomy will be compensated by a reduction in existing grants of more or less the same amount. Just like in 2001, the increase in tax autonomy for the Regions will go at the expense of the PIT grant to the Regions.

compared to the increase in tax autonomy obtained by Flemish political parties by means of the 2013 SFA revision (last but one row of table 3). Like in 2001, this increase in tax autonomy is sizeable compared to the extra grants for the FG and Brussels. Unlike in 2001, however, the new tax autonomy will only take the form of a PIT surtax, hence the FG retains the competency to determine the tax base on which the PIT surtax will be levied.

The increase in tax autonomy taken together with the increase in expenditure responsibilities of the R&Cs may be considered as a reduction in the autonomy of the FG which normally accompanies a bailout. The latter may increase the FG's fiscal discipline, even if the expenditure responsibilities taken away from the FG do not comprise pensions nor the core of health spending –which were precisely the categories that the FG failed to keep in check after Belgium's accession to the Euro.

However, it is uncertain whether the parties negotiating the 2013 SFA revision perceived matters in the same way. The extra expenditure devolution decided in 2013 was a request of Flemish political parties in its own right. It may have to be considered separately from the finding that the FG appeared unable to keep the expenditure consequences of population ageing under control. There is a parallel with earlier expenditure devolution rounds in Belgium. While these rounds may have in part been a reaction to the preceding fiscal indiscipline of the FG[59], it is not at all certain that the FG subsequently started behaving in a more fiscally disciplined way in order to avoid a next devolution round.

[59] Except for the devolution round of 2001, which occurred after a prolonged period of relative federal fiscal discipline.

4.2.3.Overall conclusion on the Belgian implicit bailouts

Note that the 4 implicit bailouts between the federal and the R&C level in the history of Belgian fiscal federalism were/are ***permanent*** in nature: they resulted/result in ***annual*** extra grants to their beneficiary governments. Moreover the refinancing of the Communities decided in 2001 as well as the 2013 refinancing of the FG implied/imply extra grants which ***increased/will increase*** annually[60].

An estimate for the size of the deterioration of the overall Belgian fiscal balance is the amount of 0.33% of GDP per year since Belgium effectively became a decentralized country in 1989, i.e. the average of the annual total amount of the 1993 and 2001 implicit bailouts over the 1989-2011 period (see row in bold in table 1). This because it seems likely to us that both implicit bailouts were not –or at least not fully- compensated with tax increases or expenditure cuts at the level of the FG, which provided the extra grants. The size of both implicit bailouts is to be attributed to the “one-size-fits-all”/”waffle-iron” nature of the 1993 and 2001 implicit bailouts, as well as to a sharing of the implicit bailout amount between the 2 Communities that has been advantageous to the Flemish Community. This amount may be an underestimation for a number of reasons. Firstly, we have only tried to estimate the soft budget effect of the transfer dependency of the R&Cs, rather than also trying to estimate the flypaper effect of their transfer dependency. Secondly, in the future this estimate will have to be revised upwards, as in 2013 it has appeared that the federal level and the Brussels Region have been able to let their fiscal balances successfully deteriorate during the preceding years in view of being granted an implicit bailout. The 2013 SFA revision may deteriorate the overall Belgian fiscal balance up to an average amount of 0.72% of GDP per year from 2014 onwards, i.e. the average sum of the 2013 federal and Brussels implicit bailouts over the 2014-2030 period (see row in bold in table 3). Again, this is because it seems likely to us that both 2013 implicit bailouts will not –or at least not fully- be compensated with tax increases or expenditure cuts at the level of the R&Cs that will experience the transfer cuts that will effectively fund these implicit bailouts.

Table 4 gives a summary of the characteristics of the Belgian implicit bailouts between the FG and the R&Cs. We may conclude from table 4 that the successive revisions of the SFA in terms of extra grants for a number of Belgian governments seem to have reduced the incentive for any individual Belgian government concerned to run a balanced budget. The main argument for this is that these additional grants have generally not been made conditional on extra controls over spending, i.e. they have not been made conditional on a reduction in the autonomy of the government that received extra grants (“blank cheque”). The 2013 implicit bailout of the Brussels Region stands out in table 4 as the best example of this practice. To some extent, the 2013 implicit bailout of the FG is an exception to this finding, as it came with a loss of autonomy for the FG.

Hence in Belgium the implicit message is given that running budget deficits is (and will be) effectively rewarded. The medium-term effect this message may have on the fiscal behaviour of Belgian

[60] The extra PIT grant decided in 1993 started to decline from 2001 onwards, while the Brussels refinancing will decrease from 2017 onwards (see tables 1 and 3).

governments is a third reason why our above estimates of the effect of the Belgian implicit bailouts on the overall fiscal balance may be optimistic.

The lack of conditions attached to Belgian implicit bailouts should be compared to the rare bailouts that happened in US history, or the support programs of the IMF. Remarkably, it was the IMF (2003 p. 11) that interpreted the 1993 and 2001 extra grants for the Communities differently, i.e. as a mere response to the fact that "the SFA of 1989 led to structural under-financing of the French and the Flemish Communities".

Table 4: Summary of the Belgian implicit bailouts between the FG and the R&Cs

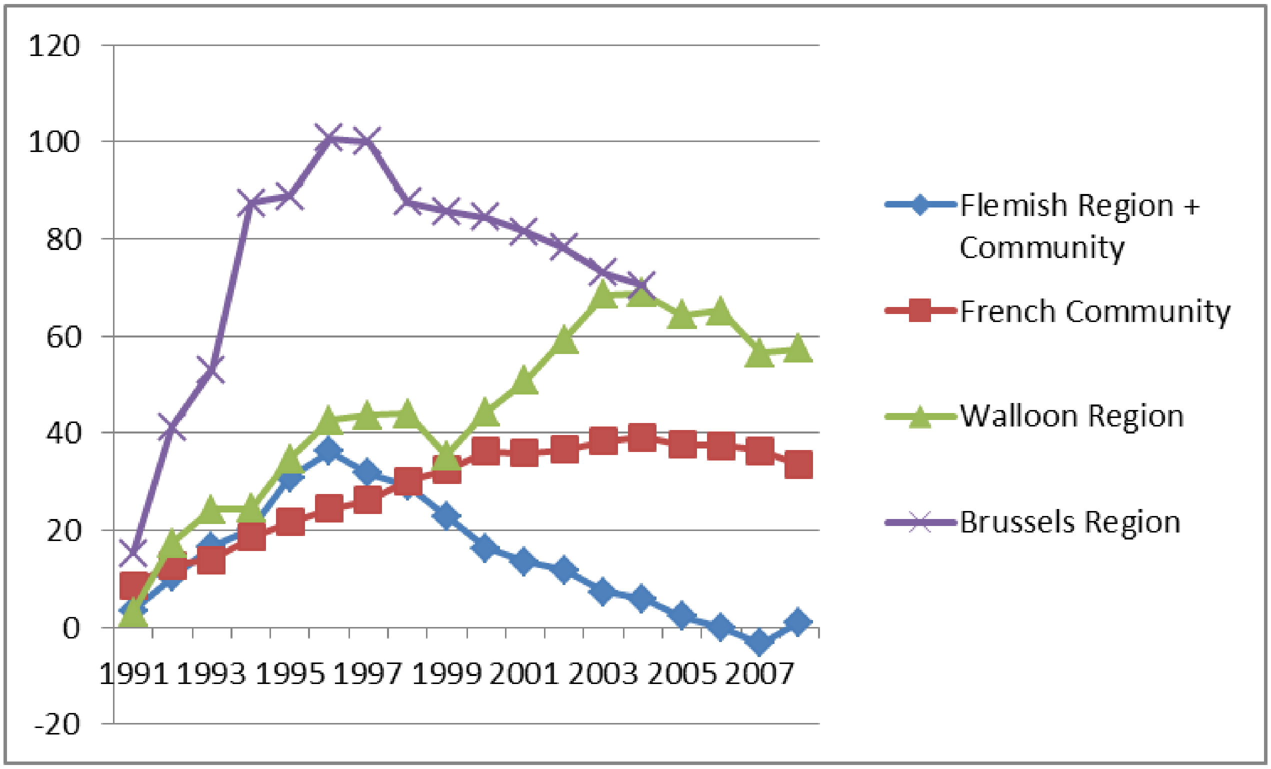
Year	**Beneficiary**	**De facto sanction in terms of reduction of responsibilities?**	**Symmetry**	**Assessment of effect on overall fiscal balance**
1993	Communities	No	Symmetrical (but Flemish Community benefited more)	Perhaps the extra grants would have become inevitable sooner or later
2001	Communities	No, on the contrary: extra tax autonomy for the R&Cs (i.e. for the Regions)	Symmetrical (but Flemish Community benefited more)	Negative: de facto reward of past moral hazard behaviour Positive: linked to tax decentralization towards the Regions
2013	Brussels Region	No, on the contrary: extra tax autonomy and expenditure responsibilities	Very asymmetrical	Negative: de facto reward of past moral hazard behaviour
2013	FG	Yes, reduction of tax and expenditure responsibilities (but not of core health and pensions expenditure responsibilities)	Quite asymmetrical (funded to the largest extent by Flanders)	Negative: de facto reward of past moral hazard behaviour Positive: - linked to a reduction of federal tax and expenditure responsibilities - linked to tax decentralization towards the Regions

Graph 9 shows the evolution of R&Cs' debts as a share of their respective revenues[61]. Except in the case of the 2013 implicit bailout of the FG and of the Brussels Region by the other R&Cs, none of the implicit bailouts between the FG and the R&Cs in the history of Belgian fiscal federalism occurred after high debt accumulation or on the occasion of imminent default of a particular government. This is precisely why all bailouts have so far been implicit. Graph 5 seems to confirm that the Belgian implicit bailouts were not a reaction to a succession of unsustainably high budget deficits either, again with the exception of the

[61] Unfortunately we have not found comparable debt data for the Brussels Region after 2004, but the repeated large deficits run by the Brussels Region from 2009 onwards, as shown by graph 6, are evidence of a further worsening of the debt situation of the Brussels Region during the years preceding the 2013 implicit bailout.

2013 implicit bailout of the FG by the R&Cs[62]. Rather the opposite seems to have held: the limited subcentral debts seem at least in part to be due to preventive federal grants increases. But in turn, these increases in federal grants were one of the causes for the federal –and hence also the overall- public debt to remain at a very high level (also see graphs 13a and b in Annex 1).

Graph 9: Public debt of the Belgian R&Cs as a share of individual R&Cs' total revenues (%)



Source: FOD Financiën

[62] Perhaps this is also why the extra grants to the Communities decided in 1993 and 2001 took some time to reach their "cruising speed". The Belgian implicit bailouts so far have been built up gradually, rather than granted right away, except in the case of Brussels in 2013.

4.3."Institutional failures" conducive to the soft budget effect in Belgium

The succession of Belgian implicit bailouts between the FG and the R&Cs can be ascribed to a number of causes. Inman (2003 p. 45-52) calls these causes "institutional failures" of a system of fiscal federalism which are conducive to the running of strategic deficits and subsequent implicit bailouts -i.e. to a soft budget constraint. Following "institutional failures" listed by Inman seem relevant to the Belgian situation:

1. ***Transfers to SCGs that are not limited to demonstrable spillovers*** (Inman 2003 p. 52), i.e. excessive grant financing of SCGs

Blöchliger and Petzold (2009 p. 12) state that "the rationale for grants as an anti-externality device is not always clear-cut and seems to be relevant in a limited number of countries with a specific institutional and fiscal background only". At the same time, substantial grant financing seems to make any "no bail-out" commitment by the CG less credible. In the wording of Wildasin (1997 p. 5): "Fiscal crises observed in some countries could be the result of too little decentralisation rather than too much decentralisation". In the wording of Rodden (2005 p. 183): "States with a large and growing dependence on federal transfers have the most rational bailout expectations". High grant financing allows lower level governments to more credibly invoke the argument that the deficits they run are not self-inflicted. Cost shifting / "free rider problems" of which extra grants to SCGs are often the embodiment seem a bigger risk in a grants-based –i.e. transfer dependent- fiscal federal system than in a tax-based fiscal federal system. Within the latter individual governments have more of an incentive as well as more capacity to deal themselves with cost increases in expenditure categories for which they are responsible. Even in the US, where the commitment of the FG not to resort to explicit bailouts is credible, Inman (2003 p. 55-56) notes that implicit bailouts in the form of too high federal transfers to local governments are widespread, with an "inefficiently too large local public sector" as a result. Hence, the large subcentral tax autonomy of the US does not seem a sufficient condition for a hard budget constraint.

Applied to Belgium: even after the decentralisation round of 2001, which comprised the largest increase in the R&Cs' tax autonomy so far, up to 80% of the revenue of the R&Cs still consisted of federal grants. This share will diminish to 68% after the 2013 decentralisation round. The Communities –which benefited from extra transfers granted in 1993 and 2001- have even been transfer-dependent for virtually 100% of their revenues since the establishment of the SFA in 1989. A paradox is Brussels: until its substantial implicit bailout in 2013, it was the Belgian SCG with the highest share of own tax revenue in its total revenue. The FG of Belgium can be considered another paradox. It has by definition always enjoyed full tax autonomy, but has run budget deficits in most years since the early 1970s, and obtained an implicit bailout in 2013[63], in terms of a net reduction of its grants to the R&Cs.

[63] The perspective slightly changes if we consider social security as an actor that is different from the FG. Since the 1990s Belgian social security has increasingly been funded with "ordinary" tax revenue, as social security contributions fell increasingly short of social security expenditures. Also in 2013, it appeared to be because of

2. CG politicians who are elected locally (in the spirit of Weingast's (1981) analysis of the common pool problem), in particular ***when local political interests dominate the CG***

In the US Congress regional interests tend to form –often nearly unanimous- coalitions to pass locally beneficial but federally costly policies (Inman 2003 p. 55). It is an example of ***how weak CGs*** –i.e. unable to commit not to bail out- ***are conducive to weak SCGs*** –i.e. unable to commit to fiscal discipline (Inman 2003 p. 41). Rodden (2005 p. 184) argues that the "local interests dominance" condition is not fulfilled for Germany: "Federal party leaders control a variety of resources that are valuable for Land politicians, thus Germany's highly integrated political parties put a ceiling on the incentives of Land politicians to position themselves for bailouts" [64].

In Belgium this condition is fulfilled very strongly:

- as opposed to presidential systems, not even the leader of the federal government (the prime minister) is elected on a country-wide basis, but only in his constituency, and
- there are no Belgium-wide political parties.

All Belgian political parties obtain votes in only one of the 2 linguistic communities (Flemish or Francophone), i.e. all Belgian political parties are regional. This seems to increase the risk of Belgium being faced with a common pool problem. A political party could always try to shift part of the "price" for a bail out of a particular lower level government to the other linguistic community. This is because a political party obtaining an implicit bailout for "its region" does not have to fear electoral punishment by "the other region" [65]. Indeed, this political party has no votes to lose within "the other region" as it never had the ambition of obtaining votes within "the other region". In Belgium this problem seems to have effectively presented itself on the occasion of the 2013 implicit bailout: part of the costs of current spending in favour of Francophone Belgium will be effectively shifted to Flanders (see row 2 in table 3).

This common pool problem seems however to be mitigated by the considerable overlap in Belgium between the political parties in power at the federal level and those in power at the R&Cs level. A party

social security expenditures that were out of control –i.e. health and pension expenditures- that the FG (i.e. social security) had to be bailed out.

[64] In the wording of Rodden (2005 p. 139): "If national party leaders have substantial capacity to discipline co-partisans at other levels of government, it is easier for the central government to implement a coherent, unified policy agenda that transcends jurisdictional divisions. Thus strong, disciplined political parties that compete in all of the states can be a solution to underlying collective goods problems in federations. National party leaders with incentives to respond to a nation-wide constituency have "encompassing" interests in national collective goods like price stability and fiscal restraint".

[65] The complete political regionalism in Belgium leads some authors to argue in favour of establishing a federal constituency, within which a –more or less limited- number of members of parliament would be elected, thereby mitigating the Belgian common pool problem. See e.g. Sas (2013); see also Eichenberger (2010) for Switzerland. However, if bailouts in a federal country like Germany have remained limited in number, this was in spite of Germany lacking a federal constituency. As a matter of fact we are not aware of any country having a federal constituency. The limited number of German bailouts seems to be partly thanks to political parties competing in all of the German states, which is precisely a feature that is missing in the Belgian setup, and which makes Belgium different from most countries.

could endanger its reelection prospects at the federal level if it is perceived to bail out a lower level government in which it is also part of the coalition. Hence, that political party seems to have an incentive to prevent that lower level government from incurring strategic deficits in the first place.

3. ***High perceived negative spillovers of not bailing out*** a SCG (“too big to fail”) (Inman 2003 p. 45-46)

In Belgium high perceived negative spillovers of not bailing out do not seem to have been the cause for the implicit bailouts of the French Community in 1993 and 2001. Politicians from the Flemish Community probably did not realize at the time that education spending is effectively “too big to fail”, i.e. that it is an important driver of economic growth. So they probably were not aware that Francophone Belgium’s education ***does*** have potential high spillover effects to their own Community, as (lack of) economic growth in one Community of Belgium probably has considerable spillover effects on the other Community.

In contrast, perceived potential negative expenditure spillovers do seem to have partly driven the 2013 implicit bailout of the Brussels Region. There is the perception that provision of local public goods by the capital city generates positive spillovers for the other 2 Regions, e.g. local public transport and safe and clean streets to its many commuters and visitors[66].

Likewise, in the run-up to the implicit bailout of the FG in 2013, Flemish political parties supporting the FG coalition have spread the perspective of the FG failing to provide average Flemish citizens with a decent pension.

4. The presence of ***SCGs on whose territory poor taxpayers are concentrated*** (Inman 2003 p. 47)

The Belgian R&Cs that have requested an implicit bailout so far –the Brussels Region and the French Community- are characterized by average incomes per capita which are considerably below the Belgian average (reflected in the lower than average federal tax revenues collected on their territories that are visible from table 2 above).

5. Rodden (2003), Bordignon and Turati (2009) and Sorribas-Navarro (2011) add to these “institutional failures” ***the subcentral expenditure responsibility for one or more key public services*** –presumably transfer-financed, and particularly consisting of health care but also education. Hence, the Francophone education sector may have been “too big to fail” for ***Francophone*** political parties ***themselves***. I.e., they may not have been able to neglect it ***politically*** speaking, rather than economically speaking, as protracted teachers’ strikes and a rise of the opposition Francophone Green party in the opinion polls preceded the 1993 implicit bailout. Also the 2001 extra grants for the Communities were requested because of fiscal

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[66] This is comparable to the “exploitation of monopoly control over an important federal public good by local politicians” that was conducive to the bailout of Washington DC in 1997, as described by Inman (2003 p. 60). However i.a. CPB (2010) demonstrates that in general spillover effects of locally provided public goods are limited –as people consume most of their public goods in their place of residence.

problems within the Francophone education sector. A final case in point is the extra –reverse- transfers from the Belgian R&Cs in favour of the federal health expenditures in 2013.

6. Rodden (2005 p. 192) adds for Germany that ***overlap in expenditure responsibilities*** between the Länder and the FG has provided an incentive for strategic deficit increases, Bremen and Saarland only being the most obvious cases in point: "Land-level politicians can always credibly claim that the blame for local policy failures or revenue shortfalls lies elsewhere, even though this is not always true" (also see Eyraud and Moreno Badia 2013a p.4-5). Expenditure overlap not only leads to higher expenditures directly[67], but also to higher deficits via tactical expenditure increases. The latter happen because the lower government's bailout expectations increase in case of expenditure categories for which responsibility is shared with the CG (Joumard and Kongsrud 2003 p. 41; Bordignon and Turati 2009 p. 306). Expenditure overlap has always existed in Belgium ever since fiscal decentralisation took off. Naturally, the FG level has regularly resisted expenditure decentralisation in Belgium, and -once expenditure categories were shifted to the R&Cs- has tried to duplicate decentralized expenditures (e.g. in the fields of preventive health care, urban renewal, development aid, and foreign trade).

[67] Joumard and Kongsrud (2003 p. 23) give a number of examples for Germany, Norway and the Netherlands in which the lack of a clear division between the spending responsibilities of higher- and lower-level spending authorities results in an inefficient use of resources. On a related note, Leibfritz (2009 p. 5) points to the excessive institutional complexity of Belgian fiscal federalism. The distinction between Regions and Communities, with the French Community covering the territory of the Brussels and Walloon Region, while being a distinct political and administrative body, seems unique from an international perspective. Eyraud and Moreno Badia (2013a p. 19) provide international evidence on the positive impact of fiscal decentralisation on expenditure duplication, and hence on a worsening of the fiscal balance.

4.4.Internal fiscal policy coordination in Belgium

Because of the permanent implicit threat of soft budget effects within any system of grants-based fiscal federalism, the latter requires coordination of the management of the overall budget deficit. In Belgium, such internal fiscal policy coordination is all the more necessary because it is part of the Euro-zone and hence has to respect the Stability and Growth Pact (SGP). In 2013 the EC even started monitoring the internal coordination of the budget balance of Eurozone-countries. E.g., Belgium was required to report by end-2013 to the EC "on the implementation of the first recommendation issued under the European Semester regarding the adoption of explicit coordination arrangements to ensure that budgetary targets are binding at the federal and sub-federal levels within a medium-term planning perspective". (DGEcfin 2013)

The Belgian practice of recent years has been that SCGs taken together should provide 35% of overall deficit reduction required by the SGP –with less effort by some SCGs being compensated by more effort by other SCGs. 35% corresponds approximately to the SCGs' share in total government expenditures. (see graph 12b in Annex 1) One way to look at this is as a case of moral hazard, because SCGs generally have incurred much less than 35% of the overall deficit (and have a much smaller share than 35% in raising taxes[68]). However another way to interpret the 65-35 rule is that it follows from the fact that the federal debt was largely incurred in times when the 35% expenditure responsibilities that now belong to the R&Cs still belonged to the CG[69].

The Belgian internal stability pacts and its accompanying fiscal rules should be regarded as a useful complement at best, and as a deficient substitute at worst, for the hard budget constraint that is fostered by tax based fiscal federalism[70]. (Blöchliger 2013 p. 37 and 53) As Wildasin (1997 p. 3) writes: "Exhortations by policy advisors to change soft budget constraints into hard ones are ultimately likely to be of limited effectiveness if institutions are structured in such a way that policymakers find ad hoc fiscal interventions to be irresistibly attractive". Wildasin (1997 p. 26) even states that the stricter the controls of the CG on the SCGs' budgets are[71] –and hence the less responsibility the SCGs have over their fiscal policies-, the higher the risk of a soft budget constraint seems to be. (see also Joumard and Kongsrud 2009 p. 43)

[68] E.g., in 2011 the R&Cs raised taxes only to the amount of 2.3% of GDP, compared to total Belgian tax revenue amounting to 44.0% of GDP (see graph 1), the bulk of the difference being accounted for by tax revenue raised by the FG. Therefore the FG seems more able to reduce its deficit by means of both expenditure cuts and tax increases than the R&Cs, which mainly seem to have expenditure decreases at their disposal to reduce their deficit.

[69] Still, a more "incentive compatible" alternative to the 65-35%-rule would be the sharing of the currently 100% federally held public debt between the FG and the R&Cs according to the 65-35% criterion. (see Heremans and Van Hecke 2010)

[70] There seems to be some similarity between the Belgian situation and the failure in Germany to increase subcentral tax autonomy during the "Föderalismusreform" of the mid-2000s, and to resort to a fiscal rule instead (the "Schuldenbremse"). (see Baskaran 2012)

[71] A related paradox is the finding by Rodden (2002) that limits to the borrowing autonomy of SCGs leads to a worsening of the budget balance.

In Canada, Switzerland and the US on the contrary, internal budget balance coordination more or less happens "automatically"/"naturally" [72]. Not by coincidence, these 3 countries are the most decentralized countries in the world in terms of own subcentral tax revenue as a share of total tax revenue. (see graphs 15a and b in Annex 2) In these countries each subgovernment has an ***interest/incentive*** to be fiscally disciplined. This is because of the credibility of the no-bailout commitment of its CG, i.e. the mix of high subcentral tax autonomy and a history of no extra grants provided by the CG[73]. Because of this credibility, "the residents of US states have chosen to create institutions (such as constitutional rules) that limit borrowing because they anticipate the adverse consequences associated with it". (Wildasin 1997 p. 27) Hence, several US states are subject to balanced budget rules, not because they have been imposed by the FG, but because they have been imposed ***by their own voters***, who have an interest in them.

Coene and Langenus (2011 p. 17) document the difficulties of intra-Belgian fiscal policy coordination[74]. However they do not seem to acknowledge sufficiently that the incentive structure for fiscal discipline within the Belgian grants-based system of fiscal federalism is skewed in the first place, as the grants system appears vulnerable to periodical discretion:

- if the R&Cs do not reduce their deficits, they may hope to be bailed out with extra grants (the French Community in 1993 and 2001 and the Brussels Region in 2013); if the federal government does not reduce its deficit, it may hope to be able to reduce its grants to the R&Cs (in 2013)
- or conversely: an SCG that runs a balanced budget may fear to be burdened with a larger share in the effort towards an overall budget balance (Flanders in 2013) (see also Ter-Minassian 2007 p. 3); in this vein, the Belgian internal fiscal policy "watchdog" HRF as well as Coene and Langenus (2011) have stated that Belgian R&Cs have few incentives to run repeated budget surpluses, and that consequently the traditional Belgian approach of compensating the fact that some governments run deficits with the requirement that other governments run surpluses seems unsustainable; this was particularly the case right before the outbreak of the financial crisis in 2008, when the

[72] Moreover, Canada, Switzerland and the US are not subject to some supranational SGP. Therefore, the ***overall*** budget deficit and the ***overall*** public debt level of these countries are almost irrelevant. (Hence, in graph 13 in Annex 1 we are in fact comparing apples and oranges.) When media discuss the current fiscal problems of the US, they only discuss the fiscal problems of the ***federal*** government –apparently without being aware of this. (David Stadelmann pointed this out to me.)

[73] However, as stated above, Inman (2003 p. 55-56) even finds a soft budget effect –and hence excessive grant financing- for the US SCGs. Moreover the financial crisis may have provided another exception to the US rule of no federal bailouts, and hence to the clear separation of its 51 fiscal policies. The recent steep rise in the US federal debt could be partly explained by soft budget constraints. The American Recovery and Reinvestment Act (ARRA) of 2009 could be partly considered as an implicit bailout of some states. There also exist a few cases of Canadian and Swiss lower governments having been bailed out in recent history. No single system of fiscal federalism seems to be immune to –albeit implicit- bailouts.

[74] For more general overviews of the difficulties coming with internal fiscal policy coordination, see Joumard and Kongsrud (2003 p. 43) and Van Hecke (2013 p. 13-14).

Flemish R&C had arrived at a point at which it had paid off its entire public debt, and thus at a point at which future budget surpluses had to be saved

It is surprising that several papers on intra-Belgian coordination of fiscal policy make a quite favourable assessment of the Belgian experiences from 1990 until 2008. See e.g. graph 7, taken from Van Meensel e.a. (2008 p. 79), which makes the authors conclude that R&Cs taken as a whole have attained their agreed fiscal balance target in each single year between 1990 and 2008. A similarly favourable assessment of internal Belgian fiscal policy coordination is made by international institutions such as DG Ecfin (Bethuyne, 2005)[75] and IMF (2008), which additionally laud the role fulfilled by the fiscal policy "watchdog" HRF[76]. These favourable assessments seem to neglect the following:

- agreed fiscal balances of the R&Cs could have been "soft" in the first place; see graph 10 by Algoed and Persyn (2009b), showing the difference between successive ***overall*** budget balance target trajectories agreed within the HRF (thin solid lines) and their achievement (thick dashed line) during the past decade; graph 10 demonstrates that ***overall*** HRF targets have never been achieved, despite the fact that new trajectories were consistently updated given the non-achievement of preceding target trajectories; hence, the apparently smooth achievement of HRF targets by ***the R&Cs*** seems mirrored in the non-achievement of ***the FG***'s targets; the repeated grants increases provided by the FG to the R&Cs contributed to the fact that the R&Cs' expenditure growth since the establishment of the SFA in 1989 has on average been higher than the FG's expenditure growth (see graph 1); at the same time the R&Cs taken together still achieved a budget surplus in most years, as opposed to the FG
- in several years the R&Cs' overall fiscal balance target has been achieved overwhelmingly thanks to the performance of the Flemish R&C, and during the beginning of the period in question also thanks to the Brussels Region[77] (see graphs 6 and 7)
- also before Belgium's accession to the Euro, R&Cs' fiscal policies seem to have been at the expense of the FG's fiscal policy; between 1992 and 2000 the budget balance of

[75] Bethuyne (2005 p. 5) concludes that "federalism has worked well for Belgium. It has given Regions and Communities effective ownership of their budgets".

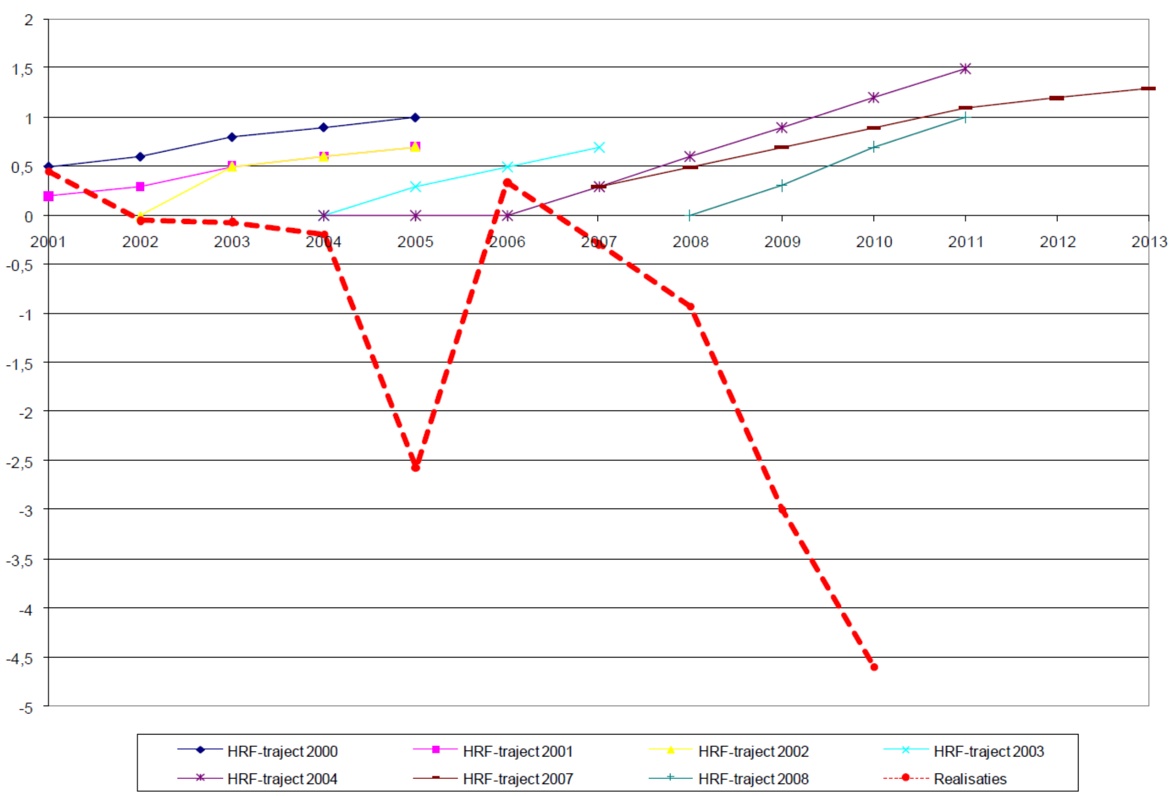
[76] More critical voices on HRF are Coene and Langenus (2011) and IMF (2013b). Coene and Langenus (2011) perceive a reduction of the HRF's consistency, independence, and impact since Belgium's Euro-accession. IMF (2013b) equally reports on the mixed track record of HRF. A disadvantage of HRF is that, though it is often labeled as "independent", its composition is determined by political parties that form the governing coalition. This composition is not without consequences. The 2004 R&C elections had for the first time in the history of Belgian fiscal federalism led to R&C government coalitions that were all different from the federal one. Following this coalition change, the HRF was not able to agree on a sharing of the burden of reducing the overall deficit, which even led to the suspension of the HRF for some time.

[77] The repeated budget surpluses of the Flemish R&C -as well as of the Brussels Region during part of the 90s- (see graph 6) could be considered a paradox. Not only do incentives for budget surpluses seem to be lacking within a context of grants-based fiscal federalism. Additionally, ever since 1989 the SFA has provided the Flemish R&C with less revenues per capita than the other Belgian R&Cs.

the FG improved by 6.5% of GDP (see graph 1), compared to only 1.1% for the subcentral level (local governments included) (OECD 2001 p. 42)

- the rule for deficit reduction sharing between the FG and the SCGs appears to have been changed a number of times in the past; apart from the 65-35 rule other rules have been used; e.g. according to the Internal Stability Pact of 2000, each Entity was required to strive for a balanced budget[78]; such changes complicate the medium-term fiscal planning of individual governments (Blöchliger 2013 p. 53), and hence possibly also their fiscal discipline
- the perceived need for periodic changes in federal grants to the R&Cs by means of the successive SFA revisions are another indication that internal fiscal policy coordination in Belgium may have been less smooth than that it is thought

Graph 10: HRF overall fiscal balance targets and their achievement



Source: Algoed and Persyn 2009b

[78] See Van Hecke (2013 p. 7) for an overview of the several Belgian internal burden sharing rules with respect to budget deficit reduction as suggested by the HRF.

5.Conclusions and recommendations

On balance, the international literature tends to agree that in general fiscal decentralisation is not harmful (and may even be beneficial) to the overall size of government and to the overall budget balance. However, the international literature also makes us conclude that the heavily grants-based nature of Belgian fiscal federalism both may have increased the cost of government and may have affected the overall budget balance negatively. It may have increased the cost of government, because grant financing has been demonstrated in a multitude of contexts to increase government expenditures since grant financing risks creating the fiscal illusion that they are financed out of taxes collected in other jurisdictions. It may have deteriorated the overall budget balance, because grant financing has been demonstrated in a number of contexts to induce deficit increasing behavior in the expectation that deficit increases will trigger an increase in grant financing (or –in case of the FG- a reduction in grant provision).

While in Belgium the grants-based nature of its fiscal federalism heavily skews the political debate towards distributional issues (which R&C receives more/less grants? is the FG underfunded -or overfunded- compared to the R&Cs?), the effects of Belgian grants-based fiscal federalism on the overall Belgian fiscal policy outcomes seem more important. The Belgian past and present have shown that both some R&Cs and the FG have been able to let their own fiscal balances successfully deteriorate, at least from their own short-term point of view. Some R&Cs have done this successfully because the Belgian grants-based system of fiscal federalism has provided them with extra transfers –without a corresponding increase in expenditure responsibilities. These extra grants may be assumed to have come at the immediate expense of the fiscal balance of the FG. Recently also the FG has been able to let its fiscal balance deteriorate successfully, because the heavily grants-based nature of Belgian fiscal federalism has allowed it to reduce its transfers to the R&Cs (except the Brussels Region). This cut in grants may be assumed to come at the immediate expense of the fiscal balance of the R&Cs (except the Brussels Region).

Even though extra grants appear only to have been allocated on average every 8 years since the voting of the original SFA in 1989 (i.e. in 1993, 2001 and 2013), and even though we have judged some implicit bailouts more harmful than others (see table 4 above), there has been debate about the ***prospect*** of such de facto rewards in many more years than in the 3 years in which they have been voted into law. Not only the effective materialization of these de facto rewards but also the prospect of them may have worsened the overall fiscal balance. Not only does it look likely that the extra grants were not (will not be) fully compensated with tax increases or expenditure cuts at the level of the government(s) who funded (will fund) them. It also seems plausible that these extra grants give an incentive to any government concerned to run a budget deficit. Hence the greatest damage of the implicit bailouts conducted may not be the ***immediate*** effect on the fiscal balance of the grants-providing government. It may instead be the “institutional environment” of non-credible no-bailout commitments they help solidify ***over the medium term***. The implicit bailouts conducted in Belgium may lead any Belgian government to believe that more implicit bailouts will follow, and hence that fiscal indiscipline will keep being effectively rewarded.

Charbit (2009 p. 7) states: “The basic message from normative principles {of fiscal federalism} is that SCG should rely on own-tax finance at the margin, with grants playing an auxiliary role to correct for externalities and to smooth inequalities across sub-central jurisdictions”. (also see Blöchliger 2013 p. 32) This prescription contrasts with the Belgian fiscal federalism tradition of grants playing the central role, and own tax-finance playing an auxiliary role. The persistently low tax autonomy of the R&Cs, the subsequent high Belgian VFG, and the subsequent high transfer dependency of the R&Cs are grounds for not even attributing Belgium the label of “fiscally decentralized country”. Ever since 1989 Belgian fiscal federalism seems to have been in conflict with the statement by Boadway and Tremblay (2012 p. 1072) that sizeable decentralized expenditures make the sharing of at least one broad-based tax category almost inevitable. While Belgian SCGs have taken care of more than 30% of overall Belgian public expenditure since the establishment of the SFA in 1989 (as shown by graph 12b in Annex 1), it lasted until 2013 before the sharing of the Belgian PIT in a 75-25 proportion was voted.

Instead of increasing subcentral tax autonomy, Belgian fiscal federalism has tried to achieve overall budget discipline by means of internal fiscal policy coordination. However, the Canadian, Swiss and US past experiences seem to suggest that “implicit fiscal institutions” such as high tax autonomy and a credible “no bail out” commitment seem more conducive to overall fiscal sustainability than “explicit fiscal institutions” such as legislation, internal stability pacts, fiscal rules and the existence of an “independent” fiscal watchdog. Hence, Boadway, one of the authors of a handbook of fiscal federalism (Boadway and Shah 2009), puts forward as a recipe for overall fiscal discipline in Canada:

- Its high subcentral tax autonomy
- Its absence of periodic revisions of CG transfers to SCGs

Remarkably, in their respective country reports on Belgium[79], international institutions acting as a watchdog over Belgian fiscal management (e.g. DGEcfin 2005, IMF 2008, OECD 2013) do not seem to be aware of the risks of the Belgian grants-based fiscal federalism in general –nor of the risks of its periodical revisions in view of allocating extra grants to one or the other Belgian government in particular. This is particularly striking in the case of the OECD Economic Surveys of Belgium:

- OECD (2013 p. 23) fears that the increase in tax autonomy of the Regions after the 2013 SFA reform may lead to upward vertical tax competition, but does not discuss its potential merits
- OECD (2011 p. 41-42) only hesitantly pleads in favour of more subcentral tax autonomy; it seems to expect an improvement of overall Belgian fiscal discipline to come from the conclusion of a Belgian internal stability pact rather than from more tax autonomy

[79] As opposed to the non-country specific publications on fiscal federalism by these institutions.

Based on these findings, policy recommendations are hard to make. Several of Inman's (2003 p. 45-60) institutional failures conducive to the soft budget effect apply to Belgium, but over the medium term their "repair" does not seem realistic. An exception seems to be Rodden's (2005 p. 192) expenditure overlap between higher and lower level governments. The expenditure overlap between the Belgian FG and the R&Cs could be reduced on the occasion of future fiscal federalism reforms, but its fiscal benefits should not be overestimated. Another exception may be Inman's (2003 p. 52) first –and, according to the empirical literature, major- institutional failure, i.e. an over-reliance on grant financing of lower level governments. Given that closing the Belgian VFG by making Belgium a unitary state again does not seem politically feasible[80], more tax autonomy for the Belgian R&Cs seems a prerequisite for more sustainable overall fiscal management. As the PIT is the obvious Belgian broad-based tax to be shared between the FG and the R&Cs (see Boadway and Shah 2009 pp. 172-175 and 191-193, see also Algoed e.a. 2008 p. 25-26), an increase in the 75-25 proportion according to which the PIT will be shared because of the 2013 SFA revision seems necessary.

Hence the remaining question is ***how*** to make a further increase in the Belgian R&Cs' tax autonomy politically acceptable. The "natural" resistance of the FG level as well as of the R&Cs with a smaller tax base against tax decentralisation will remain a considerable obstacle in the foreseeable future[81].

[80] Provided that it would be desirable, with reference to the poor fiscal management track record of the CG before Belgium became a fiscally decentralized country.

[81] (Un)fortunately, Belgium is not alone in this catch22 situation, as OECD (2012 p. 20) states: "In several cases {i.e. countries}, neither the CG, reluctant to lose central budget oversight, nor SCGs, fearing higher uncertainty over revenue, showed sufficient interest in greater tax autonomy".

Annex 1: An international comparison of fiscal decentralisation

The graphs below put the assertion that fiscal decentralisation in Belgium would have led to a reduction in the size of overall Belgian government, and/or to a reduction of Belgian public debt, into an international perspective. Graphs 11a and b show the evolution of the size of overall government for those 13 OECD countries in which subcentral expenditures –including local government expenditures-made up at least 30% of overall public expenditures by 2011[82], plus for those major OECD countries that are more centralized: France, Japan and the UK[83]. Hence, graphs 11a and b include all G7 and all EU15-countries plus Norway and Switzerland, except small and centralized Greece, Ireland, Luxemburg and Portugal. Graph 11a groups together the countries which we will argue to be the ***less*** decentralized subgroup of the 13 countries, while graph 11b groups together the countries which we will argue to be the ***most*** decentralized subgroup of the 13 countries.

For those same 2 subgroups, graphs 12a (most decentralised countries) and b (less decentralised countries) show subcentral expenditures as a % of overall public expenditures per individual country[84]. As for those countries with an important intermediate (i.e. state) government level between the central and the local government, we label the share of subcentral (= state + local) government expenditures in total government expenditures "Subcentral". As for the other countries we label the share of subcentral (= local only) government expenditures in total government expenditures "Local".

There seem to be some links between graphs 11 and 3:

- for the 13 countries in general, (at least until the economic crisis starting in 2008) a decrease in the share of public expenditure in GDP seems to have coincided with an increase in expenditure decentralisation
- the group of ***most*** decentralised OECD countries, at least in expenditure terms (graph 12a), seems to be composed to an important extent of countries with relatively ***low*** overall public expenditures (Canada, Spain, Switzerland[85], and the US), exceptions being Denmark and Sweden (graph 11b)
- the group of ***less*** decentralised OECD countries (graph 12b) seems to be composed to an important extent of countries with relatively ***high*** public expenditures (Austria, Belgium[86], Finland, France, Italy) (graph 11a)

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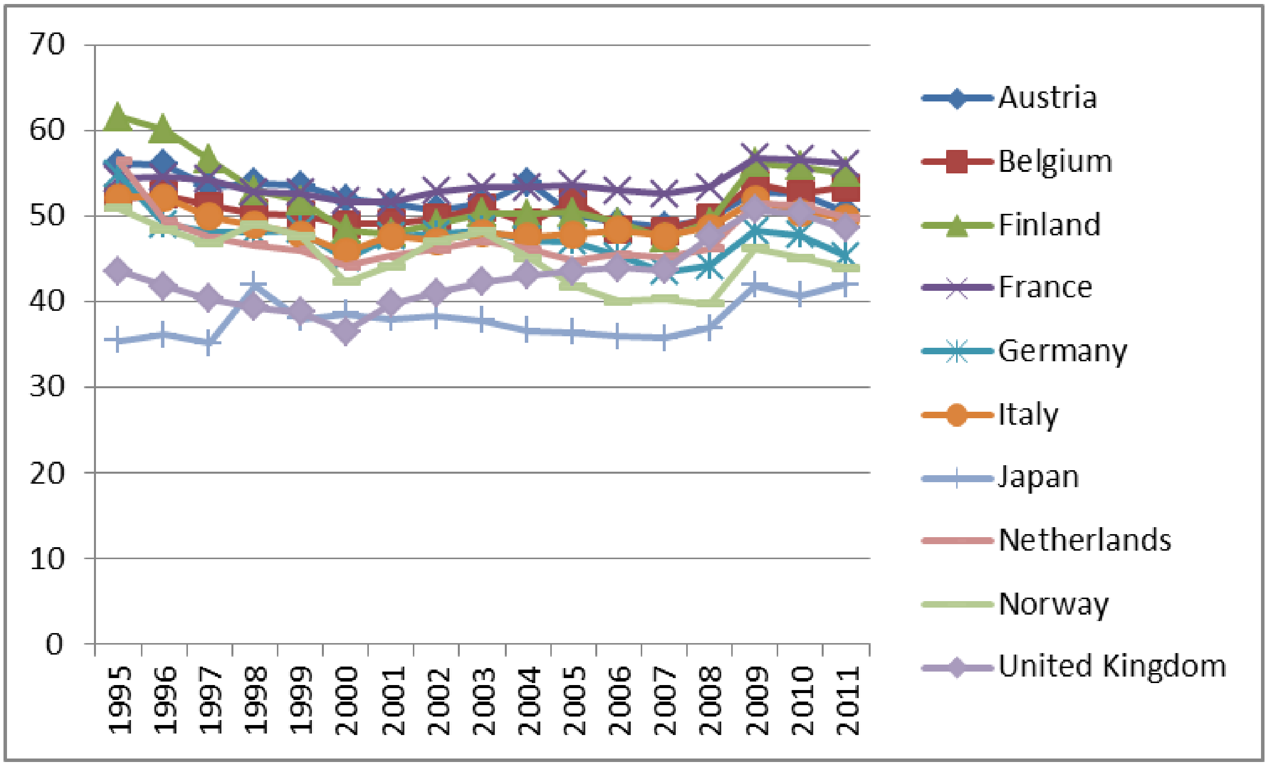
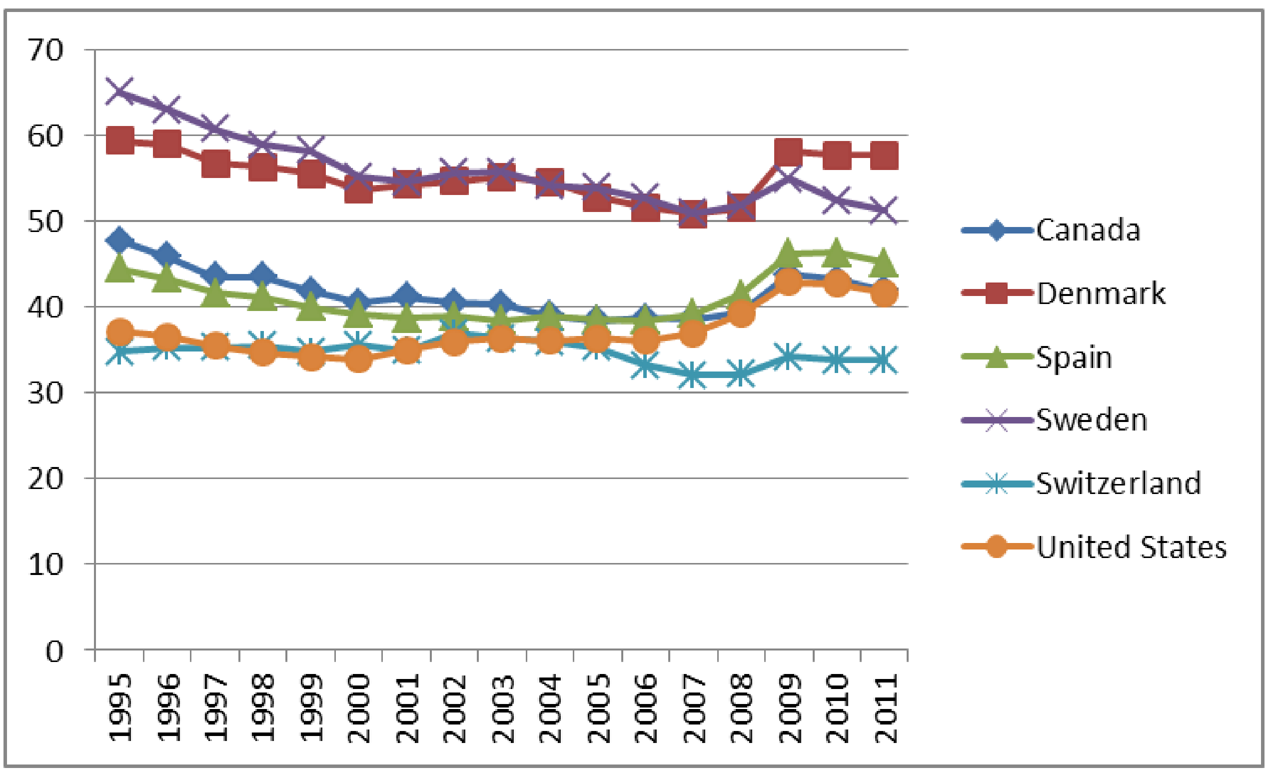
[82] On the OECD website, we did not find data for Australia.
[83] The starting year is 1995, the first year for which data are available for most OECD countries on www.oecd.org.
[84] Data are lacking for Japan.
[85] The public expenditure ratio as well as the tax burden in Switzerland is somewhat artificially deflated due to the substantial non-tax compulsory contributions towards private sector health and pension systems. When the latter are included in the tax burden, the Swiss tax burden is of a similar size as e.g. Germany's. (see Fuentes 2013 p. 5)
[86] Because of the 2013 SFA revision, the share of subcentral expenditures in total public expenditures in Belgium will increase to an estimated 45% in 2014, from 37% in 2011 (see graph 12b). Hence, from 2014 onwards Belgium will belong to the group of most decentralized OECD countries, at least at the expenditure side. Its share of subcentral expenditures will then be similar to that of Spain, Sweden, and the US in 2011 (see graph 12b).

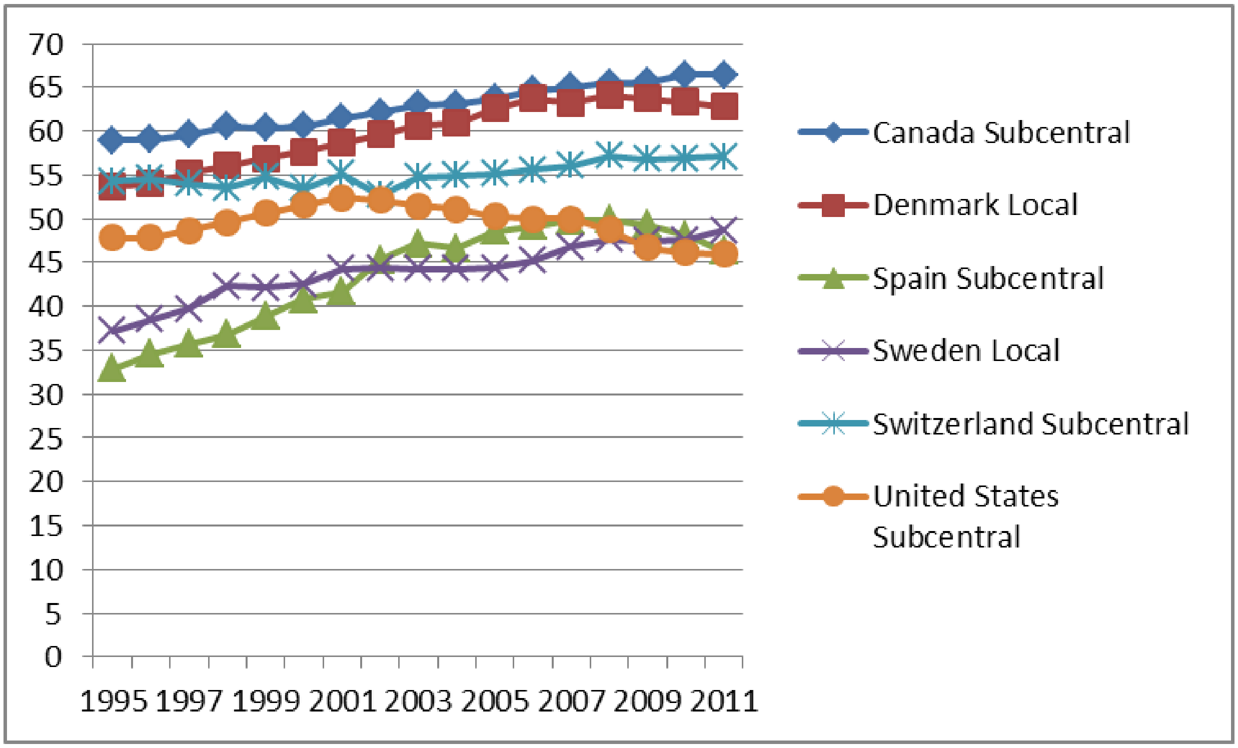
Graphs 11a and b: Overall government expenditures as % of GDP (1995-2011)

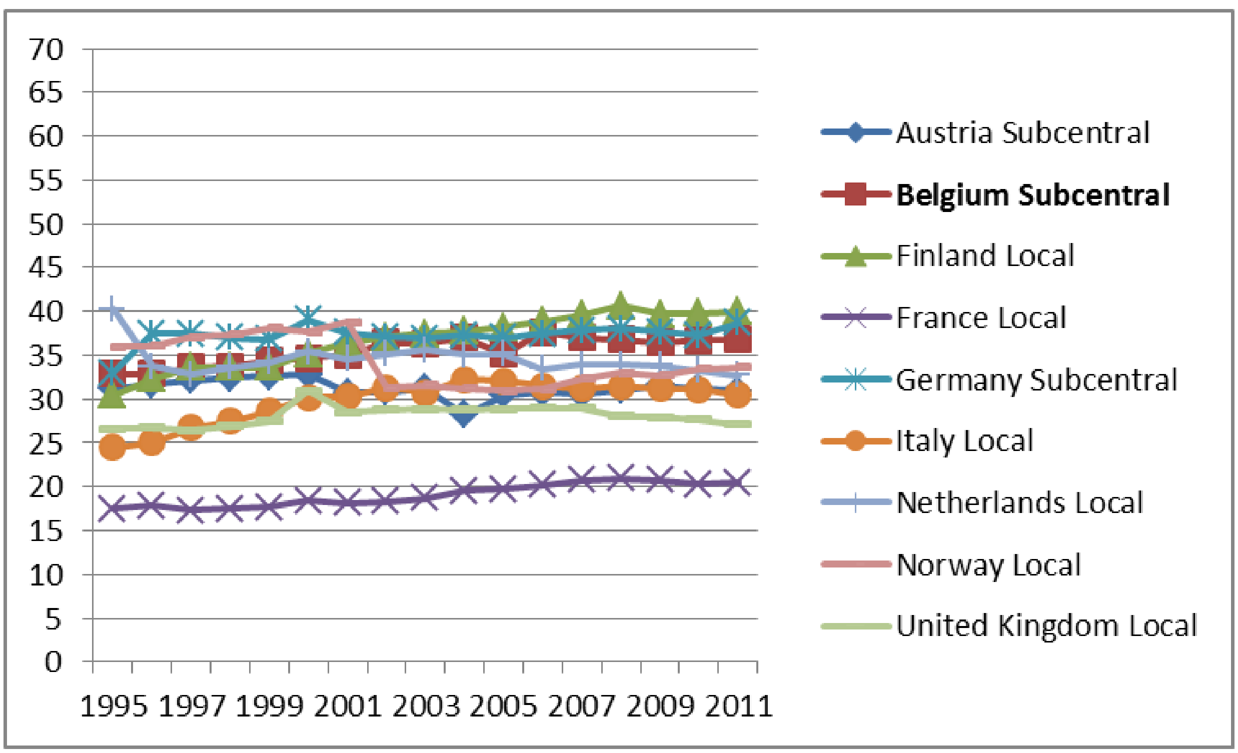




Source: OECD

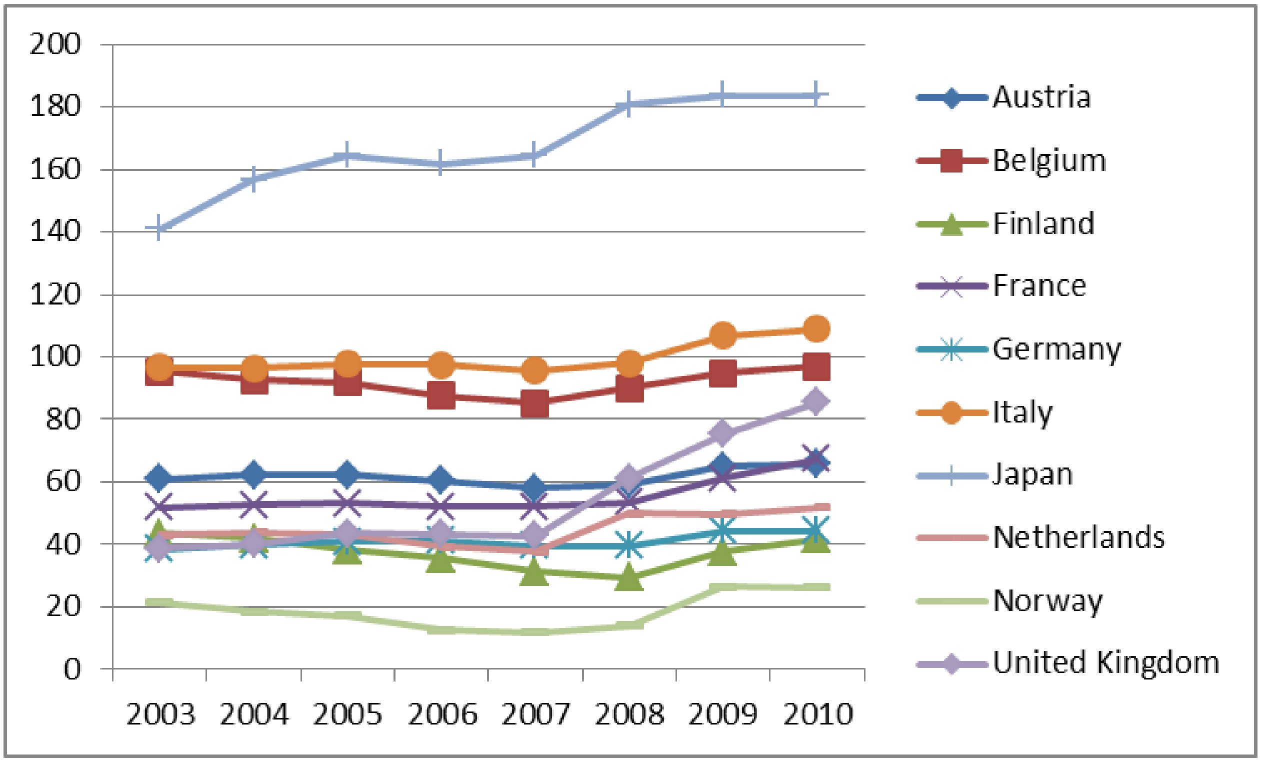
Graphs 12a and b: Subcentral public expenditures as % of overall public expenditures

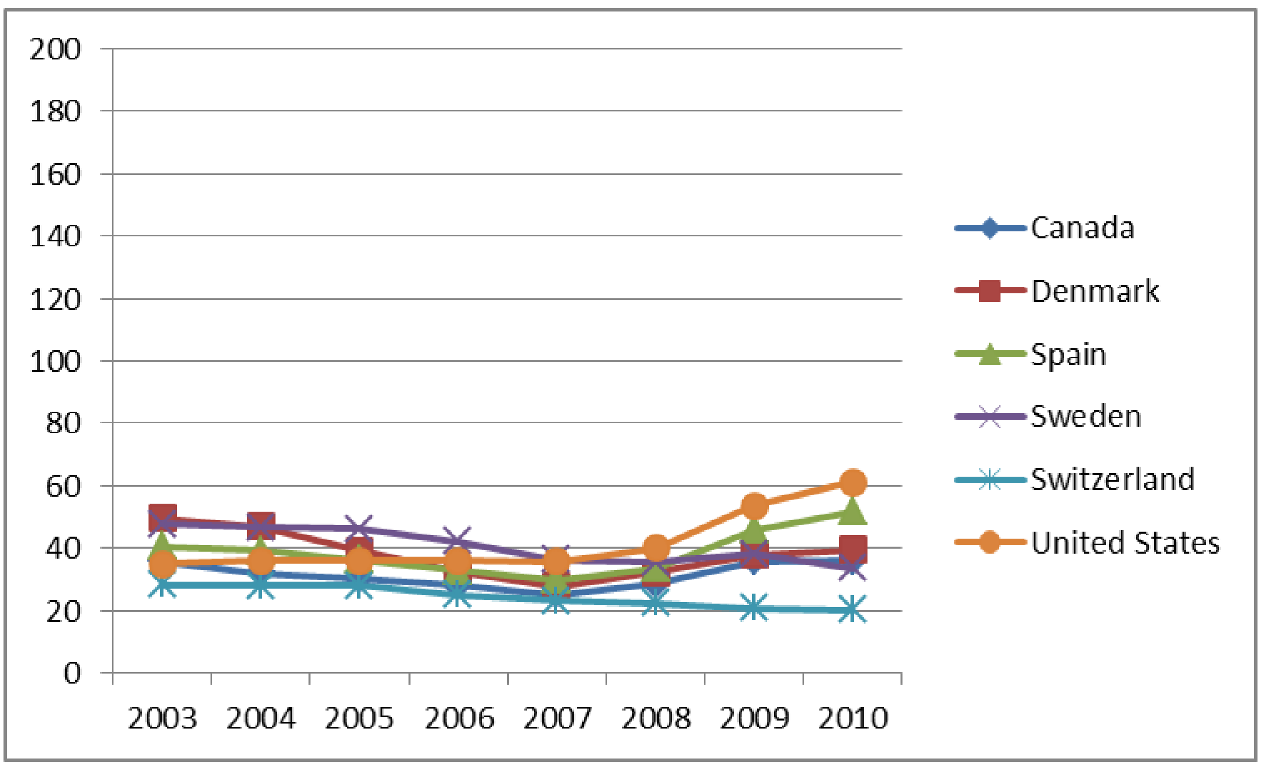




Source: OECD

Graphs 13a and b: Overall government debt as % of GDP





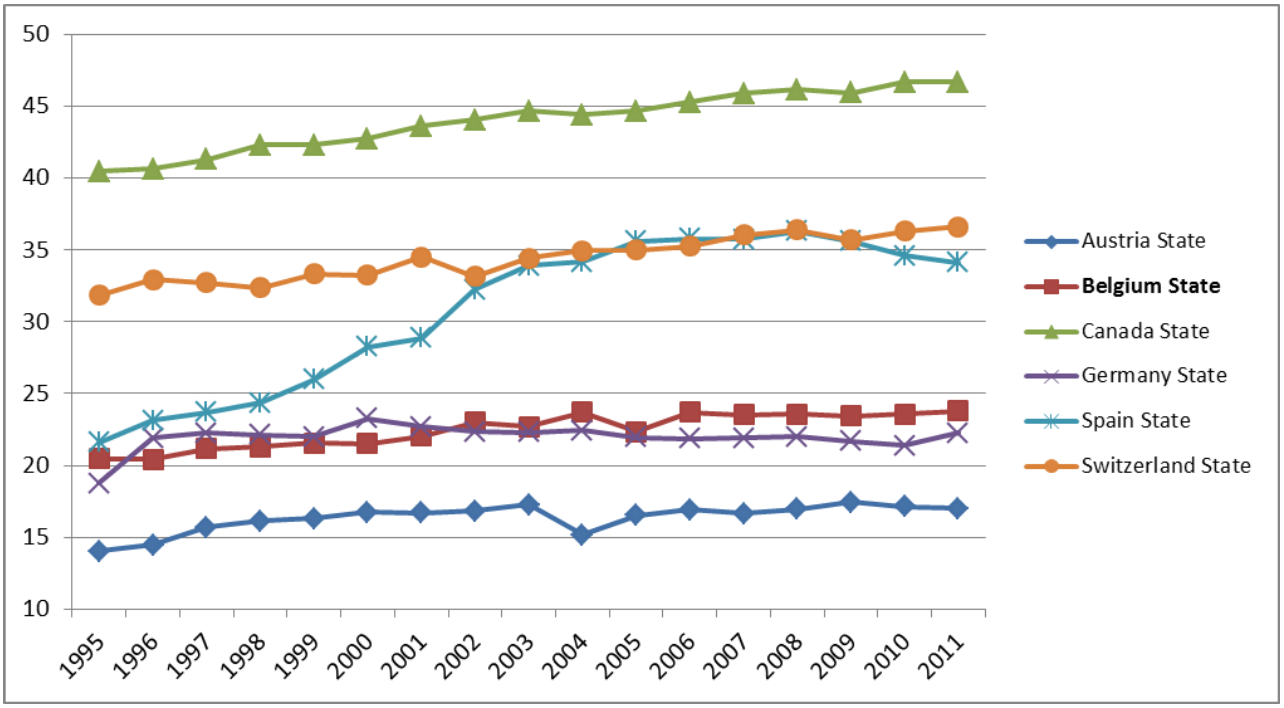
Source: OECD

Furthermore, graphs 13a and b make clear that the group of less decentralised OECD countries seems to be composed to an important extent of countries with rather high overall public debt[87]: Belgium, Italy, Japan, and since the eruption of the crisis in 2008, the UK (graph 13a). The reverse seems to hold as well: the most decentralized countries seem characterized by a rather low overall public debt level: Canada, Denmark, Spain, Sweden, Switzerland, and the US (graph 13b). Thus the graphs give the impression that fiscal decentralisation is associated with favourable fiscal outcomes.

For the sake of completeness, graph 14 shows the shares of ***state*** expenditures ***only*** in total government expenditures, for those OECD countries with an important intermediate (i.e. state) government level between the central and the local government[88]. All countries in graph 14 with a rather ***high*** share of state expenditures (Canada, Spain, Switzerland, and the US[89]) belong to the countries with rather ***low*** overall expenditures (graph 1b2, and all countries in graph 14 with a rather ***low*** share of state expenditures (Austria, Belgium[90], Germany) belong to the countries with rather ***high*** overall expenditures[91].

[87] The OECD website makes public debt data available only from 2003 onwards.
[88] Again with the exception of Australia.
[89] OECD data are lacking for the US states separately, but we may assume that the expenditure share of the US states in overall US public expenditure is rather high.
[90] Because of the 2013 SFA revision, the share of state expenditures in total public expenditures in Belgium will increase to an estimated 32% in 2014, from 24% in 2011 (see graph 14). Hence, from 2014 Belgium will belong to the group of OECD countries with a rather high share of state expenditures. Its share of state expenditures will then be similar to that of Spain and Switzerland in 2011 (see graph 14).
[91] Middle overall expenditures in the case of Germany.

Graph 14: State expenditures as % of overall public expenditures



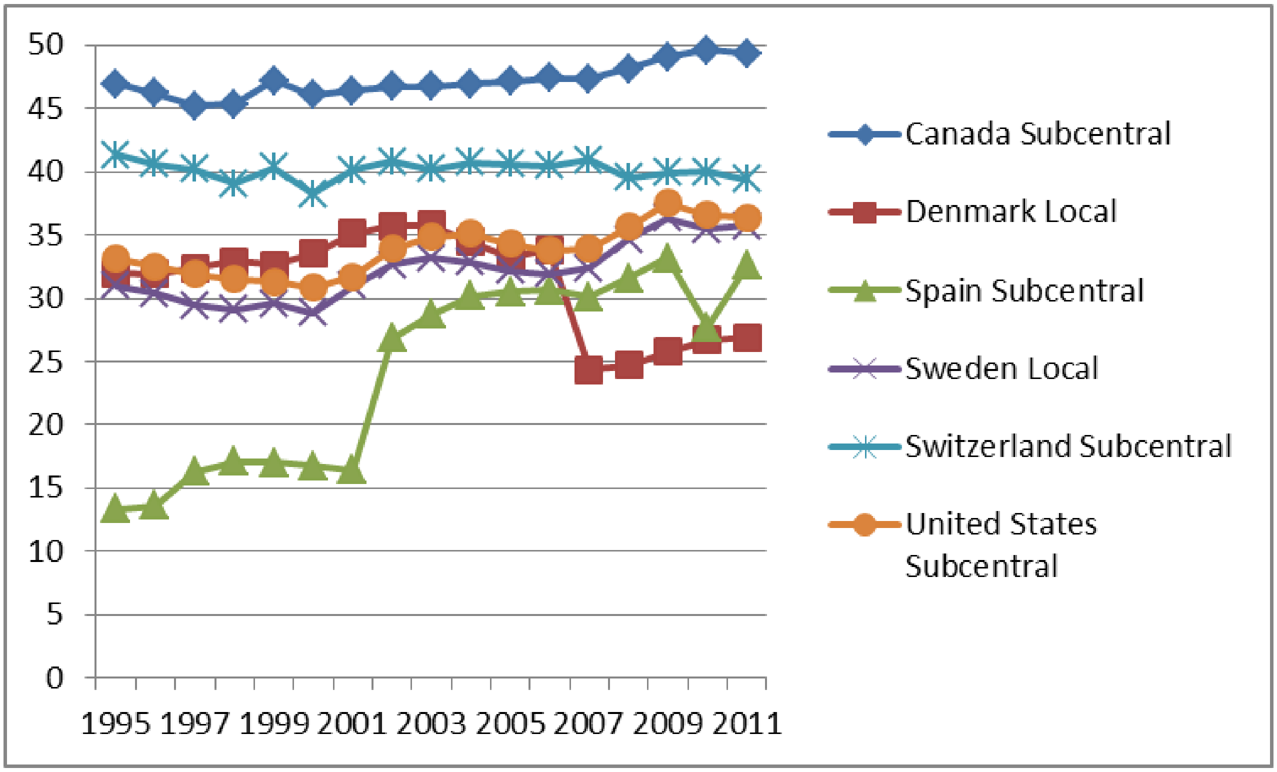
Source: OECD

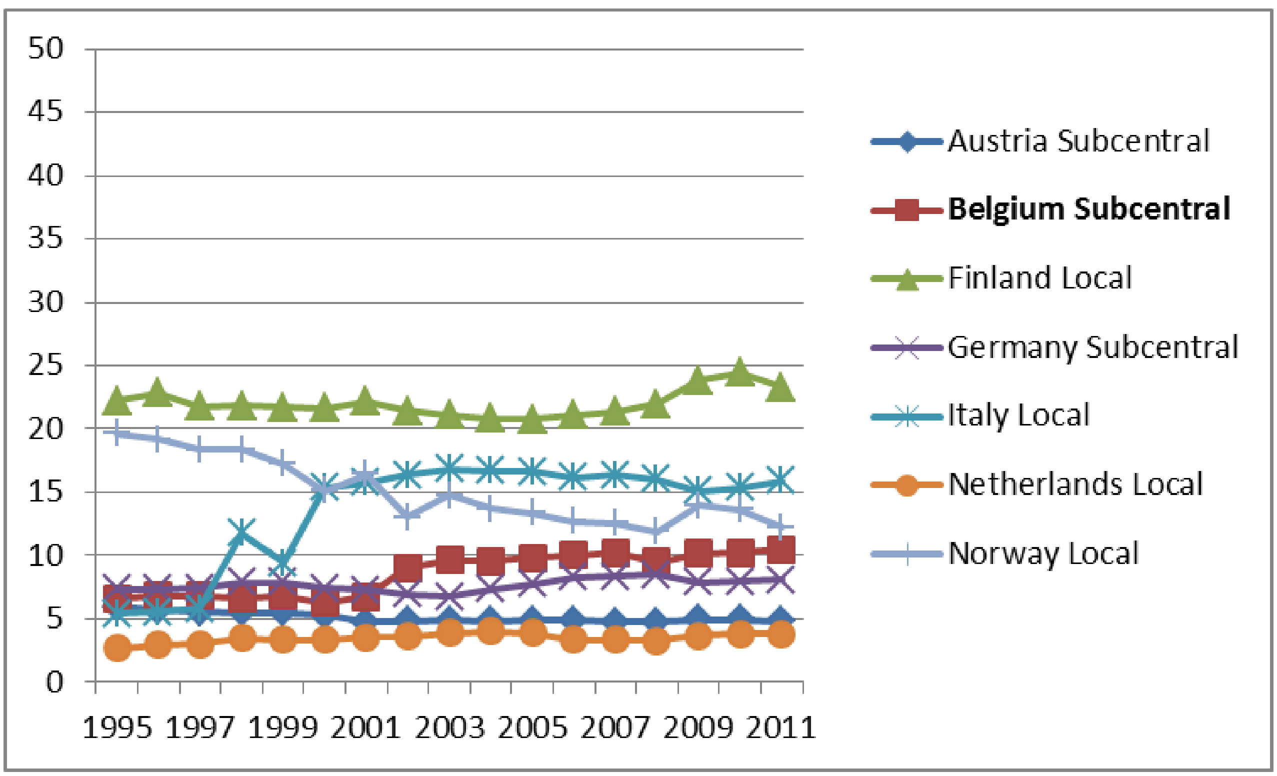
Graphs 6a and b show own subcentral ***tax revenues*** as a % of overall tax revenue for those countries of graphs 12a and b in which subcentral expenditures make up at least 30% of overall public expenditures. It appears that the group of countries with the highest subcentral ***expenditure*** share (graph 12a) is also the group of countries with the highest share of own subcentral ***tax revenue*** in total tax revenue: in decreasing order: Canada, Switzerland, the US, Sweden, Spain and Denmark[92] (graph 15a). Spain is characterized by a dramatic increase in the share of own subcentral tax revenue over the time period considered, while the reverse holds for Denmark. Because –as we will notice later on- the fiscal federalism literature attaches more importance to the subcentral share of own tax revenue in total tax revenue than to the subcentral share of public spending in total public spending, we conclude from graphs 6a and b that Canada is by far the most decentralized OECD country, followed by Switzerland, the US and Sweden[93].

[92] Because of the 2013 SFA revision, the share of subcentral own tax revenues in total tax revenues in Belgium will increase to an estimated 17% in 2014, from 10% in 2011 (see graph 15b). Hence, from 2014 Belgium will still belong to the group of OECD countries with a rather low share of subcentral own tax revenues. Its share of subcentral own tax revenue will then be similar to that of Italy in 2011 (see graph 15b).

[93] However, if we express subcentral tax autonomy as a % of GDP rather than of total tax revenue, Sweden is the most decentralized OECD country. As this status of Sweden is to a large extent attributable to its ***overall*** high share of tax revenue in GDP, we consider our measure “subcentral own tax revenue as a % of total tax revenue” more valuable.

Graphs 15a and b: Own subcentral tax revenue as % of overall tax revenue

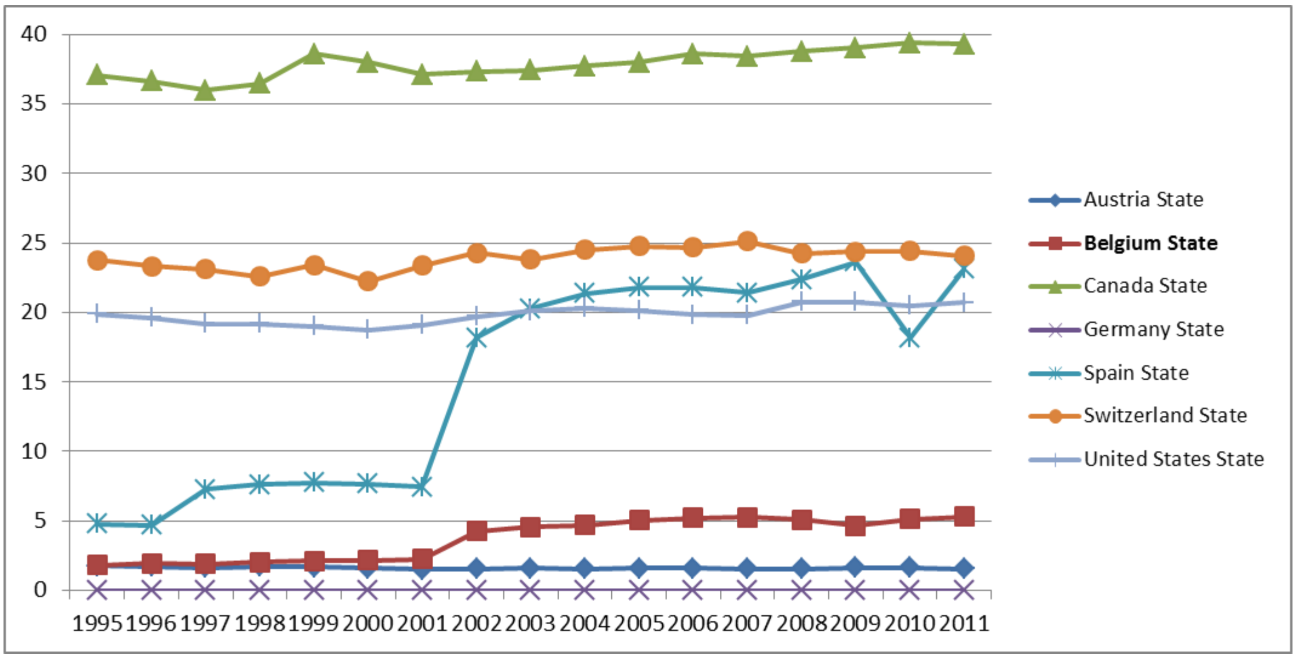




Source: OECD

For the sake of completeness, similar to graph 14, graph 7 shows the shares of own state tax revenue in total tax revenue, only for those OECD countries with an important state level[94]. Similar to the relationship between graphs 11 and 5, all countries in graph 7 with rather ***high*** own state tax revenue (Canada, Spain, Switzerland, the US) belong to the countries with rather ***low*** overall spending in graph 11, and all countries in graph 15 with rather ***low*** own state tax revenue (Austria, Belgium[95], Germany) belong to the countries with rather ***high*** overall spending[96]. Again the dramatic increase in tax autonomy for Spain is visible from graph 7, as well as the increase in subcentral tax autonomy in Belgium on the occasion of the 2001 decentralisation round.

Graph 16: Own state tax revenue as % of overall tax revenue



Source: OECD

[94] Again with the exception of Australia.
[95] Because of the 2013 SFA revision, the share of state own tax revenue in total tax revenue will increase to an estimated 12% in 2014, from 5% in 2011 (see graph 16). Hence, from 2014 Belgium will still belong to the group of countries with a rather low share of state own tax revenue (see graph 16).
[96] For Germany, we have changed the OECD data –similar to what Eyraud and Lusinyan (2012 p. 11) did-, as it appears that German states do not raise any own tax revenue, the bulk of their revenue being misleadingly called “shared taxes”, which de facto are transfers from the FG.

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